CHAPTER XII

THE REGULATORY PATTERN

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CHAPTER XII

THE REGULATORY PATTERN

A. INTRODUCTION—SELF-REGULATION IN THE SECURITIES BUSINESS

The Commission's relationship to the business it regulates is fundamentally different from that of other Federal independent administrative agencies; it is not only regulator, but also supervisor of "self"-regulators. There are, no doubt, many other instances in which the policy of entrusting a degree of social control to "private" groups has been adopted, but securities regulation is unique in featuring self-regulation as an essential and officially sanctioned part of the regulatory pattern. A major task of the study has been to assess how that technique has met the demands placed upon it and to determine how it might be strengthened and improved to meet present and future needs.

Self-regulation was originally advanced and adopted as a feature of Federal control on the ground of practicality. Initially, attention was focused on the exchanges—the over-the-counter market was too uncharted in 1934 to be capable of detailed regulation—and it was thought that the extent of the control necessary, either actually or potentially, made direct governmental intervention ineffective, if not infeasible. As John Dickinson, Assistant Secretary of Commerce and Chairman of the so-called "Roper Committee," put it in his testimony before the House of Representatives:

> In framing a regulatory measure, the practical problem of administration has always to be faced and when regulation gets beyond a certain point the sheer ineffectiveness of attempting to exercise it directly through government on a wide scale counter-balances the fact that possibly the exchanges might not be as diligent as we would wish them to be about regulating themselves or as diligent as the Government would be if the task were compact enough to fall within the limits of effective governmental performance.[1]

As indicated in the latter part of the quotation, an important limitation of self-regulation was recognized from the outset, that self-regulatory agencies might approach their regulatory duties with something less than enthusiasm. To quote Dickinson again (this time emphasizing the limitation but reverting to the theme of practicality):

> Now, it may be said, of course, cynically—and I think that there is a good deal in it, and of course we have to recognize the weakness of human nature—it may be said that the idea of self-regulation is just a device to avoid regulation and so in some instances it no doubt is; but self regulation in the first instance, with the Government holding its power in reserve to see that that self-regulation is exercised, is after all a necessary recourse in view of the mere physical limitations in time and in personnel, which operate on the direct exercise of the powers of government as the task of regulation becomes more and more extensive over a wider and wider field.[2]

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[1] Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d sess., p. 514 (1934).
[2] Ibid.

The safeguard was inherent in the original conception: it was to be the power of government held in reserve. Congressman Wolverton put the matter somewhat colorfully, in a nutshell:

> I understand that the fundamental principle * * * is this—that the exchanges should be permitted or required to regulate themselves; but there should be Federal authority holding the power which in a previous administration would have been referred to as "a big stick." [3]

Thus there was to be, not merely self-regulation, but self-regulation supervised by the Government.

The need for public supervision is at least threefold. The aspect emphasized by Dickinson, providing assurance that self-regulatory agencies actually assume responsibility for and effectively discharge those functions assigned to them instead of to the Government, hardly needs elaboration. One of the important rationales of self-regulation is that the Government's undertaking those functions would be inefficient and self-defeating. If the Government does not undertake them and self-regulatory bodies do not perform them faithfully and effectively, the result will be an appearance, a mere facade, of protection for the public that will be more dangerous than no protection at all.

Secondly, self-regulation by a member organization involves some degree of impairment of competition and public control is necessary not only to insure that such impairment is compensated for by effective regulation, but also to insure that the kinds and extent of impairment are only such and no greater than required by the exigencies of regulation. Inherent in self-regulation is the "private" formulation of restrictive standards of business conduct and their enforcement by, at the very least, exclusionary practices.[4] It is essential that the standards and their application not be left to the unfettered discretion, or perhaps even lack of bona fide regulatory purpose, of the private regulators. The accommodation of various public policies inherent in the formulation of appropriate standards and their proper application cannot be abdicated by public authority.

Finally, in some of their aspects self-regulatory agencies, at present especially the exchanges, operate as quasi-public utility institutions in relation to the general public, and in this capacity require public oversight for much the same reason that railroads, power companies, or telephone companies do. Thus, for example, exchanges actually operate a marketplace for public participants and fix minimum commission rates to be paid by such participants; operation of that marketplace and enforcement of the rates involve, perhaps consists largely of, conducting what is essentially a business affected with the public interest and therefore requiring public supervision and control. Essentially the same point applies to a self-regulatory body like the National Association of Securities Dealers (NASD) in its operation of a retail quotation system.

Similar problems of the nature and scope of public supervision may be posed in a second context, that of the organizations that do not have official status but purport to engage in self-regulatory activities for segments of the securities business not encompassed by the officially recognized self-regulatory agencies. When Congress enacted the

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[3] Id. at p. 544.
[4] See *Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1963).

Maloney Act, it was thought sufficient to "encourage" membership by relaxing the antitrust laws to permit members to discriminate in price (discounts and allowances) against nonmembers. In practice the "encouragement" has not been universally effective; important segments of the business, not having joined the NASD, are free of self-regulatory control. Certain organizations, primarily trade associations without statutory recognition as self-regulatory agencies, purport to act in the latter capacity, at least to some degree, in relation to some of the firms not embraced by statutorily sanctioned self-regulation; but their doing so may pose, perhaps even more obviously and directly, the same problems of illusory protection and need for governmental supervision that the official bodies present.

Even with adequate public supervision, however, self-regulation cannot automatically achieve the efficiency that Dickinson advanced as its basic rationale. Although he emphasized "limitations in time and personnel" on the Government side, self-regulation may present its own problems of "time and personnel" although in different form. To the extent that emphasis is placed on "self," i.e., members of an industry actually regulating themselves, self-regulation depends on the efforts of part-time volunteers who can be expected to sacrifice only a limited amount of their time and energy otherwise available for private pursuits. Some broker-dealers, those operating individual proprietorships or small firms, could hardly be expected to make such sacrifices; others, who might be more available, may be incapable or unwilling. At best, therefore, only a small segment of those active in the securities business will assume the burdens of active participation in the regulatory process. In any event, since there is necessarily a continuous turnover among member-volunteer participants, they must operate in the framework of institutions so organized, and with the assistance of such full-time staffs, as to render the volunteer effort effective to the maximum degree. Thus the balance between the roles of part-time volunteers and full-time paid staffs presents problems of theoretical and practical adjustment as the nature and scope of self-regulatory responsibility is altered by changing circumstances.

Self-regulation as it has been practiced is obviously a major theme of this entire report. Each of the substantive chapters—II dealing with qualifications, III dealing with selling and advisory activities, IV with distributions, V to VIII with trading markets, etc.—contains an analysis of rules and procedures of the self-regulatory agencies pertinent to its particular subject matter and expressly or by implication assesses the adequacy of performance of the self-regulatory role. The present chapter focuses more directly on the phenomenon of self-regulation and on the separate self-regulatory agencies as such. The NYSE and the NASD are each examined in an attempt to evaluate whether they are so constituted, in organizational structure, substantive rules, personnel, budget, and motivation, to be genuine and effective regulatory institutions and whether theirs or the Government's role, or both, should be strengthened. The American Stock Exchange is discussed principally from the point of view of changes made since the issuance of the Commission staff report on that exchange in January 1962. The regulatory procedures of the regional exchanges are briefly discussed. Certain quasi-self-regulatory orga-

nizations are also considered with a view toward determining whether their areas of concern are adequately subsumed by existing regulatory institutions. The Commission's role, both as supervisor of self-regulation and as direct regulator, is described and analyzed. Finally, attention is devoted to the question of coordination of regulatory activities among the several agencies involved. In this connection the role of the States is briefly examined.

Thus the chapter as a whole covers the various components of the present regulatory pattern, separately and in relation to each other. In conjunction with the discussions of regulation in the several substantive chapters it affords a basis for broad evaluation of the adequacy of present regulatory measures and performance. Methods of study are set forth separately in the sections dealing with the various agencies.

* * *

Since the discussion of each of the self-regulatory agencies points out what the Special Study considers to be areas of weakness in the performance of its role, it is appropriate to emphasize here—as has already been expressed in the study's letter of transmittal of April 3, 1963—that the basic statutory design of substantial reliance on industry self-regulation appears to have stood the test of time and to have worked effectively in most areas. In other words, the study has concluded that the demonstrated strengths and benefits of self-regulation outweigh its disclosed inadequacies, a conclusion which does not, however, lessen the need for directing attention to the latter and seeking remedies for them. It is also appropriate to point out that some of the difficulties experienced in self-regulatory efforts may have their counterparts, in one form or degree or another, in the Commission's own performance of its role. These are broadly considered in part I.

B. The New York Stock Exchange as a Self-Regulatory Institution

1. THE IMPORTANCE AND STRUCTURE OF THE EXCHANGE AS A REGULATORY INSTITUTION

As the most important primary market for securities, the New York Stock Exchange (NYSE or Exchange) occupies a position of leadership in the securities industry. Its rules have been widely copied and consequently assume a special significance in any analysis of the regulatory process. The Exchange's position of leadership also stems from the fact that, as seen in chapters I, VII, and VIII, its member firms handle a very significant portion of all business in over-the-counter markets and on the major regional exchanges, and the Exchange considers its members responsible to it for their conduct "in any line of business in which [they are] engaged."[5] The Exchange has not been unwilling to accept and assert this position of leadership, and, in fact, states that its rules governing member conduct are the strictest and its enforcement of those rules the most stringent.[6]

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[5] Testimony of NYSE President Funston at hearings before a subcommittee of the House Committee on Interstate and Foreign Commerce on H.J. Res. 438, 87th Cong., 1st sess., p. 108 (1961).

[6] NYSE, 1961 Annual Report, p. 5; hearings, "Stock Market Study," Senate Committee on Banking and Currency, 84th Cong., 1st sess., p. 5 (1955).

Various substantive rules of the Exchange and their enforcement have been discussed in prior chapters (especially II, III, and VI), which thus constitute at least a partial assessment of its self-regulatory performance. This part of the report will describe and evaluate the structure and operations of the Exchange as a self-regulatory body and will assess its government, organization, and machinery for the regulation of the conduct of its members.

In such an evaluation it is important to bear in mind that thousands of transactions take place daily in the Exchange's market without difficulty and without provoking disagreement. Still, in measuring the regulatory performance of the Exchange, it is necessary to point out the shortcomings that appear in its regulatory apparatus and to appraise the manner in which it responds to the questionable transactions that occur, few though these may be in the context of its total volume of transactions.[7]

The study's inquiry into the regulatory process of the Exchange took several forms. The president of the Exchange testified at public hearings conducted by the study on the subjects of entry into the securities business and selling practices in the industry. In private hearings past and present governors and Exchange staff members, including four vice presidents, testified with regard to their official duties. Minutes of the board of governors, advisory committee, and the floor governors were examined, as were disciplinary, complaint, examiners', admissions, and arbitration files. Past Exchange and Commission reports were reviewed, as well as material obtained in the course of the Special Study relating to the various substantive areas which involve the Exchange and its members.

The Exchange traces its origins as a securities market to 1792. It became registered as a national securities exchange on October 1, 1934, pursuant to section 6 of the Exchange Act. Its purposes are set forth in article I, section 2, of its constitution:

> Its objects shall be to furnish Exchange rooms for the convenient transaction of their business by its members; to furnish other facilities for its members and allied members; to maintain high standards of commercial honor and integrity among its members and allied members; and to promote and inculcate just and equitable principles of trade and business.

A membership association, the Exchange is "owned" by the 1,366 individuals who hold "seats" or memberships. Ownership of a seat entitles the holder to the privileges of membership and an equity interest in the assets of the Exchange. A seat must be held personally in the name of an individual and cannot be owned by a firm or corporation. The regulatory power of the Exchange over the conduct of member organizations, their stockholders, partners and employees derives from the Exchange's control over the member who owns a seat and who must be a partner or voting stockholder and director of a member organization. The member, as well as his partners or co-voting stockholders (known as "allied members"), are held responsible for the acts or omissions of their member organizations.[8]

[7] It is also important to realize that the NYSE operated as a marketplace prior to the enactment of the Exchange Act and that it had rules governing members' conduct at that time. The Exchange Act formally engrafted self-regulatory responsibilities on the NYSE and other national securities exchanges. This should be contrasted with the establishment of a separate association, the NASD, to govern conduct in the over-the-counter market, discussed in pt. G, below.

[8] NYSE constitution, art. XIV, sec. 16. Exchange rules and procedures relating to the admission of members and approval of member firms, including standards of qualifications for individual members acting in particular capacities, are discussed in ch. II.B.2.c.

The regulatory functions of the Exchange are vested in its board of governors,[9] which is elected, except for the president and the public governors, by vote of its membership. They are actually carried out by the board itself, various formal and informal committees, consisting principally of regular members, and a permanent paid Exchange staff which is subject to the board's overall jurisdiction. The principal committees of the Exchange are the advisory committee, nominating committee, informal committee, and, in effect, the floor governors. The Exchange staff, headed by a paid president, performs its functions through three main branches: administration and finance, operations, and public relations and market development.

The organization, powers and functions of the board, the committees and the staff are set forth in the following section of this part (sec. 2). The procedures employed by the Exchange to regulate the conduct of members and member firms off the floor are reviewed in section 3. Section 4 deals with the regulation of the conduct of members on the floor of the Exchange. Regulatory activities on and off the floor are treated separately because of the widely differing administration of the respective requirements. Section 5 deals with the arbitration procedures of the Exchange, which are made available to the public in connection with disputes with members. Section 6 describes the Exchange's public relations and advertising program, and section 7 deals with the methods employed by the Exchange to enforce the controls over issuers contained in the listing agreement and company manual. Section 8 discusses recent developments at the Exchange, and the final section contains a summary, conclusions, and recommendations.

2. GOVERNMENT OF THE EXCHANGE

a. Historical background

At the time the Exchange Act was enacted, in 1934, the government of the NYSE was vested in a governing committee consisting of 40 members and the president, who was a regular member of the Exchange. The Exchange constitution provided for various standing committees appointed by the governing committee, which operated the Exchange. Although there was a paid staff, it played a minor role in regulatory matters. The principal disciplinary agency was the committee on business conduct, which was responsible for investigating alleged improper activities and for disciplining members.[10]

The legislative history of the Exchange Act indicates the intention of Congress that exchanges should be operated as public institutions and not as private clubs for the benefit of their members.[11] The congressional purpose was reflected in section 19(c), which directed the Commission to study the rules of national securities exchanges covering the classification of members, the method of election of officers and committees to insure fair representation of the membership, and the suspension, expulsion, and disciplining of members. In a report to Congress in January 1935, the Commission made 11 recommendations for changing the rules of the exchanges,[12] but proposed voluntary action by the exchanges rather than legislation.

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[9] NYSE constitution, art. III, sec. 1.

[10] See S. Rept. 1455, 73d Cong., 2d sess., pp. 77–81 (1934), for a discusssion of the government of the exchanges at that time.

[11] H. Doc. 1383, 73d Cong., 2d sess., p. 15 (1934).

[12] H. Doc. 85, 74th Cong., 1st sess., p. 17 (1935). The principal thrust of the recommendations was directed at the NYSE.

The first recommendation was that commission brokers who deal directly with the public should be better represented on the governing committee. The report pointed out that office partners who did not own seats were not eligible for election to the governing committee despite the fact that these partners might have greater executive, administrative, and business ability than the floor partners holding seats, and commented on the unduly small percentage of commission firms represented on the governing committee.[13] The Commission also recommended that nomination to the governing committee should be by petition and not through a nominating committee, since the nominating committee system resulted in the self-perpetuation of an "in" group, and that one-third of the governing committee, instead of one-fourth, be elected annually in order to prevent perpetuation of control.[14] It also proposed that the president be elected by petition of the full membership and that nonmembers be considered for this post and other executive positions,[15] and that membership on the standing committees should not be restricted to members of the governing committee.[16]

Although many of the 1935 report recommendations were ultimately put into effect, they were not all adopted immediately. Along with other Commission proposals, they were the subject of extended negotiations between the Commission and the Exchange relating to a reorganization of the Exchange's governmental structure. The negotiations broke down in November 1937 before action had resulted on many of the proposals.[17]

In December 1937, the Exchange president, Charles R. Gay, appointed a committee for the study of the organization and administration of the Exchange. In January 1938 this committee, which came to be known as the Conway Committee,[18] rendered its report making far-reaching recommendations as to the Exchange's method of operation.[19] Among them was the suggestion that the board include office partners of New York-based member firms, office partners of firms based outside of New York, and representatives of the public. To end the criticism that the Exchange was run by a "self-perpetuating" group, the report also recommended that after serving two consecutive terms as a governor, a member should be ineligible for election for at least 1 year. It proposed that the office of chairman of the board (chairman) be created, and that a nonmember paid president be elected, with the authority to appoint all officers except the chairman and vice chairman. While it did not recommend that the standing committees be abolished, it did propose that adequate executive personnel be developed to relieve committee members of administrative duties. It contemplated that the standing committees, which were to be reduced in number from 17 to 6, would act as policymakers and the staff would be the administrators. The Conway Committee recom-

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[13] See sec. b(1), below, for discussion of the present composition of the board.

[14] See sec. b(2), below, for discussion of the present manner of election of members of the board of governors, including the present functions of the nominating committee.

[15] Presently the president is elected by the board of governors and may not be a member. See sec. g, below.

[16] Other recommendations dealt with arbitration, changes in procedures regarding the handling of customers' complaints, and the right of appeal to the governing committee.

[17] 2 Loss, Securities Regulation 1180 (2d ed. 1961).

[18] For its chairman, Carle Conway.

[19] NYSE, "Final Report of the Committee for the Study of the Organization and Administration of the New York Stock Exchange" (1938).

mendations were approved by the members and became effective in May 1938.

Between the release of the Conway report and the members' vote on the constitutional proposals which resulted from it, the Exchange, in March 1938, announced the suspension of the firm of Richard Whitney & Co. and Whitney's expulsion from the Exchange. The Commission promptly ordered public hearings to determine the necessity for additional legislation or rules and regulations affecting national securities exchanges. After extensive hearings, the Commission concluded that a "dangerous outmoded philosophy * * * dominated the affairs of the Exchange, * * * characterized by the unwritten code of silence respecting the financial condition or misconduct of a member such as Richard Whitney." It added that the Exchange had been administered "as if it were a private social club where the misconduct of members and officers was regarded as a purely private affair and of no public concern." [20] The Commission, after taking the management of the Exchange and several members to task for failing to take vigorous enforcement action in light of widespread evidence of Whitney's weakened financial condition, indicated its satisfaction with various proposals made by the new administration which had assumed control, particularly in the area of higher standards of financial responsibility.

Although the Exchange abandoned its standing committee system in 1941, there are still permanent committees in its present structure. Special committees are periodically appointed by the president or the chairman to deal with various Exchange matters.

Important changes in the constitution and policies of the Exchange occurred in 1949–50 as a result of proposals made by a group of floor members known as the Committee of 17.[21] The proposals of this committee have been attributed by leading governors at least in part to the difficult economic conditions on the Exchange at that time, particularly for its floor members. They were aimed at improving the position of these members vis-a-vis the other members of the Exchange community.

In general, the committee recommended that the board be increased in size and that the active floor members be given greater representation. It indicated its belief that the staff had to some extent assumed functions of the board, and proposed that a modified committee government be installed. It stated that, despite the recommendation of the Conway Committee, self-perpetuation of the governing board continued and it proposed a 3-year interval after two terms in office. The committee also recommended that the Exchange make greater efforts in the areas of public relations and advertising. Finally it proposed that the Exchange repeal certain floor trading rules which it claimed were inhibiting a free auction market.

Most of the proposals of the Committee of 17 were adopted in one form or another. Its recommendations resulted in the increase of the board to its present size and composition and in the establishment of the present system of floor governors. The recommendation of a 3-year interval after two terms on the board was changed to two, but the recommended expansion in the Exchange's public relations and ad-

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[20] S.E.C., *In the Matter of Richard Whitney* 177 (1938).

[21] The chairman of this group testified that only floor members were included because "* * * an office partner, unless he owns a seat, has not a voice in it."

vertising program took root in the early 1950's, and the suggestions for changes in the Exchange's floor trading rules were also ultimately successful.[22]

b. Board of governors

(1) *Powers and composition*

The constitution of the Exchange vests in a 33-man board of governors [23] all powers necessary for the government of the Exchange, the regulation of the conduct of members (regular and allied) and member organizations, and the promotion of its welfare, objects, and purposes.[24] The board is expressly authorized to adopt rules, prescribe and impose penalties for the violation of rules, and interpret the constitution.[25] In order to exercise its regulatory authority, it is given the power of general supervision over members, allied members, member firms, and member corporations, and may examine the business conduct and financial condition of members and regulate partnership and corporation arrangements, branch offices, and employees.[26] The board passes on applications for listing securities on the Exchange, and may suspend or remove securities from listing.[27]

The board meets weekly, although its 12 out-of-town and public governors are only expected to attend the monthly policy meetings. During 1959–61, average attendance at regular board meetings was 17 governors, while average attendance at policy meetings was 28.

The 33 members of the board include the chairman, the president, a total of 28 members in three specific categories, and three representatives of the public. The constitution provides that membership in the three categories (hereafter described as categories A, B, and C) shall consist of the following:

A. Thirteen regular members residing and having their principal places of business within the metropolitan area of the city of New York. At least 7 of these must be partners or voting stockholders of organizations "engaged in a business involving direct contact with the public," and at least 10 must spend "a substantial part of their time on the floor of the Exchange."

B. Five allied members and one regular member residing and having their principal places of business in the metropolitan area, all of whom must be partners or voting stockholders of organizations "engaged in a business involving direct contact with the public."

C. Nine regular or allied members (at least two of whom must be regular members) residing and having their principal places of business outside the metropolitan area, who must be partners or voting stockholders of organizations "engaged in a business involving direct contact with the public." [28]

The constitutional provisions fixing the composition of the board reflect the varying interests of different types of members. Firms engaged in a public commission business are represented by at least

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[22] See ch. VI.F, for discussion of the history of regulation of floor trading on the NYSE.
[23] NYSE constitution, art. II.
[24] NYSE constitution, art. III, sec. 1.
[25] NYSE constitution, art. III, secs. 1, 11; also see NYSE constitution, art. III, sec. 5, for provisions as to the vote needed to adopt, repeal, or amend a rule.
[26] NYSE constitution, art. III, sec. 6.
[27] NYSE constitution, art. III, sec. 7.
[28] NYSE constitution, art. II.

14 members of the board in categories B and C who are office partners of firms engaged in a business involving direct contact with the public.[29] In addition, 7 of the 13 regular members elected under category A and the regular member elected under category B are supposed to be partners of firms engaged in a business involving direct contact with the public. These provisions are responsive to the viewpoint expressed in the Commission's 1935 report to the effect that commission firms are more sensitive to the needs of the public since these firms deal directly with the public.[30] Out-of-town member firms are represented by nine governors in recognition of the national character of the Exchange.[31]

On the other hand, the composition of the board also reflects the interests of the "owners" of the Exchange, i.e., the seatholders. Of the 29 governors elected by the membership, 17, or more than half, are required to be regular members.[32] Regular membership requires ownership of a seat, and may relate principally to the specialized skill of that partner in executing orders on the floor. The office partners responsible for the overall direction and administration of commission houses are generally not regular members. The current constitutional requirement that at least 10 of the governors spend a substantial part of their time on the Exchange floor became effective in May 1950 as a result of the efforts of the Committee of 17, and illustrates the floor orientation of its proposals. Previously there had been no requirement that regular members on the board spend a substantial part of their time on the floor. After the May 1962 election the floor was represented on the board by 13 governors in category A and the chairman.

Perhaps the most important floor interest with board representation is the Exchange specialist group. The added representation which specialists were able to acquire as a result of the constitutional amendment of 1950 is evident from chart XII–1. After the election of May 1949, the last one held before the constitutional change, specialists held 2 of the 22 positions elected by the membership (9 percent). After the election of May 1962, specialists held 7 of the 29 positions elected by the membership (24 percent). Two the seven specialists were elected to the board as general partners of member firms "engaged in a business involving direct contact with the public."[33] Under current constitutional provisions it is also possible for a specialist to be elected in category B if his firm also does a public business.

Despite the objections of the Committee of 17 to self-perpetuation of the governing board and the resulting 2-year interval between

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[29] The five allied members from category B are necessarily office partners, while all of the governors from category C, as out-of-town members, must also be office partners.

[30] H. Doc. 85, 74th Cong., 1st sess., p. 8 (1935).

[31] The 1961 nominating committee recommended that the number of out-of-town governors be increased from 9 to 12 in view of the increase in listed share volume outside of Metropolitan New York City; the growth of certain regional exchanges; the lack of adequate representation of Chicago on the board over a 23-year period; the contribution of out-of-town governors in bringing about listings, creating goodwill, guiding prospective member firms, and bringing objective points of view to the Exchange on policy matters; and the ability of out-of-town governors to carry the concept of "Wall Street" to "Main Street." The committee also recommended that the number of regular members in New York be increased by 2 from 13 to 15. The board rejected these proposals.

[32] The chairman, 13 members from New York under category A, 1 member from New York under category B, and 2 members from outside New York under category C.

[33] The two are John A. Coleman, a partner in Adler, Coleman & Co., and Benjamin Einhorn, a partner in Astor & Ross. Both firms do a commission business with the public, but are principally specialist firms. Coleman described his public customers as "intimate friends," and stated that: "We are not in the commission business. This is just an accommodation." Einhorn testified that his firm did not maintain an active sales organization.

board service after two terms, certain members have served on the board with considerable continuity over a substantial period of time. John A. Coleman has been a member of the board during 21 of the last 26 years, and chairman during 4 of those years. Robert L. Stott has been a member of the board for 16 of the last 26 years, and chairman during 2 of them. In 22 years Robert P. Boylan was a member of the board for 17 and chairman during 3, and Richard M. Crooks has served 14 out of 17 years on the board, with 3 of those years as chairman.

(2) *Method of selection*

By the Exchange constitution, 29 of the 33 members of the board of governors [34] are elected by the members from among candidates proposed by the nominating committee or by petition. In practice, such members of the board are selected by the nominating committee, as there has rarely been a necessity for an actual membership vote. The term of office of elected members, apart from the chairman, is 3 years; a maximum of 10 such governors are elected in any single year.

The nominating committee is composed of six regular and three allied members, none of whom may be members of the board of governors.[35] They are elected annually at the Exchange election, and are nominated by the members of the predecessor committee, none of whom may be elected for the ensuing year.[36] The nominating committee is required to hold one or more meetings in March of each year, to which members, allied members, and limited partners and nonvoting stockholders in member organizations are invited, and to report its nominations, including those for the next nominating committee, by the second Monday in April.[37] Within 2 weeks thereafter, members may propose independent candidates. The independent nominating procedure has not been used since 1943. In that election the two candidates who were so nominated were defeated in the election. Absent independent nominations, the nominating committee customarily nominates one candidate for each vacancy to be filled.

The three public governors are nominated by the president and must be approved by the board.[38] Each public governor has a vote at board meetings. They are expected to attend the monthly policy meetings; like the out-of-town governors they are not expected to attend the more routine weekly meetings.[39] The public governors who have served during the past several years are generally drawn from two broad categories: corporate executives of companies listed on the Exchange and educators.

c. Advisory committee

The advisory committee consists of seven members of the board of governors who are regular or allied members residing and having their principal places of business in New York, selected on a rotating basis by the chairman, subject to board approval. Each serves for a 3-month term.

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[34] Excluding the president of the Exchange and the three representatives of the public.
[35] NYSE constitution, art. VII, sec. 2.
[36] Ibid.
[37] NYSE constitution, art. VII, sec. 3.
[38] NYSE constitution, art. III, sec. 3.
[39] Of a total of 33 policy meetings during the years 1959–61, 12 were attended by 3 public governors, 14 by 2, 6 by 1, and no public governors attended one such meeting. No public governors attended four of the six special disciplinary meetings during this period.

The committee, which came into existence in 1941 when the standing committees were abolished, performs an important role in the Exchange governmental structure. The NYSE constitution authorizes the board of governors to delegate to a committee the power to hold summary proceedings and to impose penalties not exceeding a fine of $250 for each violation of the Exchange constitution or rules, but not in excess of $5,000 in any one proceeding,[40] and the board has delegated this power to the advisory committee. The committee principally hears cases involving violations of the Exchange's net capital rule and reports its decisions to the board for its information.

In addition to its disciplinary powers, the committee passes on a broad range of questions before they are considered by the board, including policy matters, and recommends to the board the allocation of securities to specialists based upon the recommendation of the floor governors, which it almost invariably follows. Members of the Exchange are entitled to appeal adverse staff decisions to the board of governors, but the appeal is heard initially by the advisory committee.[41] Prior to January 1963, this occasionally took the form of appeals by firms on behalf of registered representatives who were disciplined by the staff, since until that time, registered representatives had no personal right to appeal.

The composition of the advisory committee again reflects the influence of the floor in Exchange government. There are 19 governors eligible for the advisory committee (categories A and B) ; of these, 13 are generally active on the floor. Consequently there is considerable overlapping of membership of the advisory committee and the floor governors,[42] and it is not surprising that the advisory committee generally follows floor governor recommendations.

d. Floor governors and floor officials

Those members of the board who spend a substantial part of their time on the floor have acquired a special status and are known as the floor governors. The floor governors are not referred to in the NYSE constitution or rules, but they constitute a significant separate entity which holds periodic meetings and acts as a body on a variety of questions affecting the floor and its operations. In addition, the floor governors have recognized powers and responsibilities in their individual capacities.

Although certain governors may have been known as floor governors prior to 1950, testimony indicates that the institution became significant only after the success of the program of the Committee of 17. One former chairman attributed the growth of their importance to the fact that specialists did not like the way specialist allocations were being handled (by the advisory committee). Another former chairman testified that floor members did not want to appear before "strangers," i.e., office partners.

During the years 1957–62, there were 14 floor governors: the 13 regular members elected in category A and the chairman. Since 1959, seven floor governors have been specialists; the representation of specialists as floor governors has shown a marked increase since 1949, as reflected on chart XII–1.

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[40] NYSE constitution, art. XIV, sec. 15.
[41] NYSE constitution, art. III, sec. 1.
[42] See discussion in sec. 2.d, below.

Under the present system, the floor governors are extremely important in regulating activities on the floor of the Exchange. Acting individually, they are responsible for keeping order and for supervising unusual situations. For example, a floor governor may supervise an opening when there is a heavy influx of buy or sell orders or approve a transaction more than a specified number of points from the previous one.[43]

The floor governors also meet periodically, at the instance of the chairman, to consider various floor matters. They recommend the allocation of securities to specialists and the unit of trading in newly listed securities, and they pass on mergers between specialist units. These recommendations must in turn be approved by the advisory committee and the board of governors. All aspects of floor operations are discussed by the floor governors, including such questions as quotations, post space, congestion, and undignified conduct by members and their clerks. The floor governors as a group also have the authority to ban stop orders in listed securities and to rescind such bans.

In particular instances the floor governors determine whether individual specialists have properly performed their function of maintaining a fair and orderly market. On occasion the specialist involved will appear before the floor governors to present his side of the case. These proceedings have the flavor of disciplinary actions. A determination by the floor governors that a specialist has performed inadequately with respect to a particular stock may lead to a recommendation by them to the advisory committee and the board of governors that the stock be reassigned to another specialist, or they may on their own authority place the specialist on probation for a stated period, assuring him of particular supervisory attention during the probationary period.[44]

The floor governors appear to have all the characteristics of a standing committee, including the fact they are all governors, although they have not been so reported in the Exchange's registration statement filed with the Commission. Their interposition between the Exchange staff and the floor members has resulted in regulatory procedures for floor members different from those applicable to nonfloor members.[45] Since floor governors are considered experts on floor procedures and practices, their de facto authority in this area may be comparable to the authority of the board itself.[46]

While the NYSE rules do not reflect the existence of floor governors, they do provide for floor officials, who are members but not governors of the Exchange with power to supervise and regulate active openings and unusual situations that may arise on the floor. The floor officials, of whom there are now 26 apart from floor governors, are appointed by the president with the approval of the board.[47] They are considerably less influential than the floor gover-

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[43] See ch. VI.D.6.j.

[44] Under the procedure in effect until October 1962, floor governors were further drawn into the disciplinary process when the chairman referred a trading irregularity to a particular governor for investigation. This procedure is discussed in greater detail in sec. 4(a), below.

[45] See further discussion in sec. 4(a), below.

[46] The board authorized the floor governors to consider specialist allocations and recommend to the advisory committee in a resolution of Dec. 1, 1949. Power over stop orders was given to the floor governors on Sept. 19, 1957.

[47] NYSE rules, pp. 46–47.

nors, and a floor official is likely to call in a floor governor in a serious problem situation. For the past 3 years over 50 percent of the floor officials have been specialists, a figure which is considerably higher than that of several years ago (see chart XII–1).

e. Informal committee

In the relationship between the board of governors and the Exchange staff, the informal committee, consisting of the chairman, vice chairman, and president of the Exchange, performs an important regulatory function in connection with disciplinary matters, although like the institution of floor governors it is not formally recognized by the NYSE constitution or rules. Before charges may be filed with the board by the staff against a member, allied member, or member organization, the committee must consider the charges and grant its approval. The informal committee thus acts as a screening mechanism to assure that only serious disciplinary matters are referred to the board for its consideration.

f. Chairman and vice chairman of the board

The chairman of the board is nominated by the nominating committee and elected by the regular membership of the Exchange for a 1-year term at the annual election.[48] He presides at meetings of the board and is authorized to call special meetings of the board or the regular membership. He is an ex officio member of any committee authorized by the board,[49] including the advisory committee. The chairman is considered to be a floor governor and attends meetings of that group. He has the power, subject to board approval, to appoint members of committees to consider matters relating to Exchange administration.[50]

The chairman plays a critical role in the disciplinary machinery of the Exchange, apart from his participation as a member of the board. He is a member of the informal committee, and has special responsibilities in supervising floor conduct. Acting as a floor governor he shares responsibility for supervising unusual trading situations. As chairman he has additional prestige, and is considered "chief on the floor." Under the procedure in effect prior to October 1962, all floor irregularities were reviewed by the chairman and his views were of considerable importance. A leading governor described the chairman as "* * * the one, in my opinion, to protect the members' interest. He is alongside the president in relation to the operation of the staff." The chairman must be a regular member of the Exchange [51] and traditionally has been a floor member.

In the absence of the chairman, the vice chairman assumes his functions and duties.[52] He is elected by the board at its first meeting after the annual election.[53] The vice chairman is also a member of the informal committee and as such, participates in the disciplinary process of the Exchange. He is also generally a floor member.

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[48] NYSE constitution, art. VII, sec. 1.
[49] NYSE constitution, art. IV, sec. 4.
[50] NYSE constitution, art. IV, sec. 6.
[51] NYSE constitution, art. II.
[52] NYSE constitution, art. V, sec. 1.
[53] NYSE constitution, art. III, sec. 3.

g. President

The President is the chief executive officer of the Exchange and is responsible for the management and administration of its affairs. He acts as its official representative in all public matters. He is authorized to call special meetings of the board and may, with board approval, appoint members of committees to consider "public matters."[54] As chief executive officer, the president has the power to hire staff personnel and employ professional advisers. The staff is responsible directly to the president, who is responsible in turn to the board of which he is a member.

Under the constitution the board may delegate any of its powers to the president,[55] and it has delegated broad powers to him to operate the Exchange. Among these are the power to question members, their partners and employees, and the power to call for the books and records of members and member organizations. The president periodically redelegates this authority to the staff, and this redelegation is the basis for staff action in the regulatory area.

Apart from his membership on the board, the president has a wide range of regulatory and disciplinary responsibilities. He is informed of the more important disciplinary cases as they are developed and processed by the staff. He must approve reports by the staff to the advisory committee regarding disciplinary matters. He also serves as a member of the informal committee and is generally kept advised as to the progress of regulatory functions performed by the Exchange.

h. Staff

The staff of the Exchange is directly responsible to the president and, as indicated above, derives its power principally from the redelegation of authority which empowers it to act in the name of the board. Most important from the regulatory point of view is the power to question members, their partners and employees, and to call for the production of books and records. This authority is freely exercised, particularly by the department of member firms.

As of January 1962, the staff of the Exchange and subsidiary companies[56] included 1,536 employees, of whom 226 performed regulatory functions. The staff is divided into three main branches, each headed by a senior vice president: administration and finance, operations, and public relations and market development.

The branch of operations, under the direction of the executive vice president, is the principal regulatory group of the Exchange, although its duties also include certain nonregulatory or service functions and the branch of public relations performs some regulatory functions. Operations encompasses the floor department, the department of member firms, the secretary's office, the Stock Clearing Corp., and the department of stock list. The floor department is responsible for floor operations and the detection of violations taking place on the floor.[57] The department of member firms is responsible for the regulation of the conduct of members, their partners and employees, off the floor of the Exchange, and includes the chief examiner's office, the di-

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[54] NYSE constitution, art. VI, sec. 3.
[55] NYSE constitution, art. III. sec. 1.
[56] NYSE Building Co., New York Quotation Co., Stock Clearing Corp., Newex Corp., and Newin Corp.
[57] Further discussion of the operations of this department is contained in sec. 4, below, and in ch. VI. D, above.

visions of finance, documents, margins, stock watching, commissions, member firm personnel, investigations, conduct, and complaints, and the department of member firms liaison.[58] The secretary's office is responsible for processing applications by proposed members, member organizations, allied members, limited partners, nonvoting stockholders and subordinated lenders,[59] and also for supervising the arbitration facilities of the Exchange.[60] The department of stock list passes on original and additional listing applications, recommends delisting of securities, enforces the provisions of listing agreements and the company manual, and maintains close contacts with listed companies.[61]

The branch of administration and finance is principally responsible for housekeeping functions, such as the controller's office, the NYSE Building Co., and personnel. It has no regulatory duties.

The third main branch, public relations, administers the Exchange's advertising and public relations program and its research and statistics activities. Except for its review of advertising, market letters, and sales literature of member firms, the branch has no regulatory functions.[62]

.i. Budget

The operations of the Exchange involve a major business undertaking requiring very substantial expenditures and receipts. The expenses of operating the Exchange rose sharply during the 1957–61 period. In 1957, the net consolidated expenses were $14,606,347. This grew steadily through 1961, when the Exchange had net consolidated expenses of $20,545,939. The largest categories of Exchange expenses are those of its floor operations, its ticker, quotations and telephone systems, the NYSE Building Co., the Stock Clearing Corp., its advertising and promotion program, and the department of member firms. The largest single item of expense in 1961 was for the cost of operating the floor, which amounted to $3,639,246. The expenses of the department of member firms were substantial, though not as great as several other categories of expense, amounting to $1,053,155 in 1961. Table XII–1 reflects Exchange expenditures for the years 1957–61 inclusive, by department.

For the year 1961 the Exchange had total revenues of $23,930,639 and total expenses of $20,430,551. Its six largest sources of revenue were its fee charged on members' commissions and odd-lot dealer transactions, its initial and continuing listing fees, the charges for ticker service, stock clearing, and quotation service, and its membership dues. The Exchange levies a charge of 1 percent on the net commission charged by member firms and one-eighth of 1 cent per share traded on odd-lot transactions.[63] These charges brought in $7,187,343 in 1961. The initial and continuing listing fees charged to issuers brought in $6,188,705 and the ticker system produced $3,440,345. Charges to members and nonmembers on the ticker system are geared to earn 7½ percent on the Exchange's capital investment. Charges to members by the Stock Clearing Corp., geared to return 6 percent on the Ex-

[58] The operations of the department of member firms are discussed in sec. 3, below.
[59] See ch. II.B.2.c.
[60] See sec. 5, below.
[61] See sec. 7, below.
[62] More detailed discussions of the regulatory functions and the Exchange's public relations program are contained in secs. 3.b and 6, respectively.
[63] NYSE constitution, art. X, sec. 2.

change's capital investment, resulted in revenues of $1,847,133 in 1961.[64] The quotation service brought in $1,099,446 and membership dues brought in $1,031,275. In 1962 the NYSE had total revenues of $25,162,345 and total expenses of $21,403,343.

j. Formulation and adoption of policy

(1) *Formulation of policy*

The formulation of policy for the Exchange is principally the responsibility of the board. In the exercise of its authority to regulate the business conduct of members, the board has the power to adopt such rules as it deems appropriate.[65] Furthermore, constitutional amendments are in most cases approved by the board before submission to the membership.[66]

Exchange policy is principally embodied in the constitution, rules, and "supplementary material" which appears after each rule. These can be found in the NYSE Guide published for the Exchange by a private firm. Changes in the policies embodied in the constitution can only be made after a vote of the membership. Rules are adopted and amended by the board; supplementary material is generally the result of board action, although it is occasionally promulgated by the staff.

While the constitution deals primarily with the structure and powers of the Exchange and the rules and supplementary material deal more with day-to-day operating problems, a number of highly significant policies are embodied in rules and supplementary material. The organization of this material is not always consistent, and in many instances it would appear that no clear standards determine whether a particular policy should be promulgated in the form of a rule or in supplementary material. For example, rule 312 requires the Exchange to be notified of certain changes within member organizations, none of which relate to qualifications. The supplementary material following the rule sets forth certain important qualification standards, such as the requirement that floor members and allied members pass examinations and that allied members be sponsored.[67] Another example of supplementary material following a rule which does not relate to what appears in the rule itself is rule 110 which deals exclusively with floor trading, while the following supplementary material contains the requirement that specialists state the full size of the offer unless the exercise of their brokerage function makes it inadvisable.[68] Similarly, rule 440 requires members and member firms to make and preserve certain books and records for at least 3 years, but supplementary material to this rule, among other matters, provide standards relating to furnishing statistical and investment advisory services by members to professional nonmembers.[69]

The organization of the material in this manner not only limits the usefulness of the NYSE Guide, making it difficult to locate particular policies, but also can lead to awkwardness in charges in disciplinary

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[64] On July 12, 1963, the Exchange advised its members that the basis of determining the charges on these and other "mutualized services" would be changed in accordance with the recommendations of a special committee.

[65] NYSE constitution, art. III, sec. 1.

[66] NYSE constitution, art. XIX. A petition of 175 Exchange members seeking an amendment to the constitution must be submitted to the membership for a vote after the board has had the proposed amendment for a period of 7 weeks.

[67] NYSE Guide, par. No. 2312.

[68] NYSE Guide, par. No. 2110.27.

[69] NYSE Guide, par. No. 2440A.

proceedings brought by the staff, which must be framed in terms of a violation of rules, regardless of the relevance of the rule to a violation of a policy set forth under supplementary material which may follow the rule.

Although most Exchange policies are embodied in the NYSE Guide in one form or another, there are some Exchange standards and requirements which cannot be found there. For example, the criteria applied by the NYSE with respect to underwriters' compensation, which are described in chapter IV.B.2.c(2)(c), were not the subject of a written communication to the membership or of a statement in the guide.

(2) *Right to vote on constitutional amendments*

Exchange members are entitled to vote at the annual election and on constitutional amendments.[70] As already indicated, under the present nominating committee procedures the right to vote at elections has largely become a formality, although it could resume significance if these procedures were changed. On the other hand, many of the most important Exchange policies, such as the minimum commission rate schedule, are incorporated in its constitution, which can be amended only by vote of the members. In considering the Exchange's policy-making functions, therefore, it is relevant to consider the composition of the membership which is entitled to vote.

Under its constitution, only regular members, or those holding seats on the Exchange, are entitled to vote.[71] According to the Exchange's registration statement filed in May 1962, there were 1,366 seats outstanding of which specialists, floor traders, odd-lot brokers and dealers, and floor brokers accounted for 668.[72] This compared with 648 seats held by member firm partners. Fifty seats were stated to be "inactive."

That more seats were held by floor professionals than member firm partners is attributable to the fact that the floor professionals must invest in seats in order to conduct their operations. An individual cannot operate as a specialist or odd-lot broker, for example, without owning a seat. In order to expand floor operations, additional seats are needed. There are two specialist firms with as many as 10 seats and others with almost as many.[73] The associate brokers affiliated with the two major odd-lot firms own approximately 100 seats, while the firms themselves had partners with 26 seats as of January 4, 1963. On the other hand, a commission firm can build a network of branch offices, yet have only one seat owned by a partner of the firm. For example, as of the same date, Dempsey-Tegeler & Co., Inc., a member firm with 49 branch offices, had only one partner who owned a seat.

In considering the importance of particular groups in affecting Exchange policy, the Special Study examined the relationship between Exchange firms doing business with the public and the number of seats held by those firms. Three factors were considered in the measurement of the extent of a firm's relationship with the public: amount of commission income, number of registered representatives, and

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[70] NYSE constitution, art. VII, sec. 8; art. XIX.

[71] Ibid.

[72] 360 specialists, 161 floor brokers, 117 odd-lot dealers and brokers, and 30 floor traders.

[73] As of January 4, 1963, Spear, Leads & Kellogg, and Wagner, Stott & Co., both specialist firms, had partners owning 10 seats. Another specialist firm, Adler, Coleman & Co., had partners owning 9 seats, while Marcus & Co., had partners owning 8 seats.

number of branch offices. Together, these factors give a reasonable indication of the extent of direct contact these firms have with the public.

The study discloses that firms accounting for 50 percent of total commission income, 48.1 percent of total registered representatives, and 42.2 percent of total branch offices hold only 7.1 percent of the total number of seats. At the same time, firms and individual members (consisting principally of floor professionals) that account for 10 percent of commission income, 10.4 percent of total registered representatives, and 12.5 percent of total branch offices, hold 59.7 percent of the total number of seats. Furthermore, firms and individuals accounting for 3 percent of commission income and approximately 1.5 percent each of total registered representatives and branch offices hold 33.5 percent of the total number of seats (chart XII-2 and table XII-2).

In response to a question as to why only regular members can vote on constitutional amendments and at Exchange elections, a prominent governor testified that:

> They are truly the owners of the Exchange and those responsible. They have the greatest interest in the Exchange.

This fails to take into account the substantial financial interest which many allied members have in their member firms, which may exceed the interests of the partners holding seats in their names. The popularity of a-b-c agreements [74] for financing the purchase of seats, which are controlled by firms, although held in the names of individual partners, illustrates the fact that regular members frequently have no greater stake in the Exchange than allied members. Allied members are subject to the same kind of investigation and qualification standards as regular members.[75] In any event it is clear that the seat concept results in a preponderance of voting power being lodged in floor professionals.

3. REGULATION OF THE CONDUCT OF MEMBERS, ALLIED MEMBERS, AND MEMBER ORGANIZATIONS OFF THE FLOOR OF THE EXCHANGE

The NYSE's regulation of conduct of its membership may be most conveniently discussed in terms of conduct off the floor (in this section) and conduct on the floor (in sec. 4). This division reflects not only the quite distinct areas of members' activities involved but also the Exchange's rather separate regulatory arrangements and procedures for dealing with them.

a. Surveillance procedures

(1) *Examiners' visits*

The Exchange has three principal techniques for determining whether members, their partners and employees are complying with Exchange standards of proper conduct off the floor of the Exchange: financial questionnaires and visits by Exchange examiners, public complaints and its stock watching program. Possibly the most important of these is the program of examination and insepection of members carried on by the chief examiner's office through a review of periodic

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[74] Described above in ch. II.B.2.c.
[75] See ch. II.B.2.c.

financial questionnaires and visits to the offices of members and member organizations. The examinations are used to detect violations of numerous Exchange and Federal requirements, but are particularly valuable in determining compliance with the Exchange's net capital rule [76] and the various credit regulations.

The financial questionnaire requirements of each firm depend upon the category within which the firm falls. The Exchange has established three such categories: firms carrying accounts for customers (full requirements firms); firms doing business with the public but not carrying customers' accounts (introducing firms); and firms dealing only with other members. Full requirements firms, of which there were 527 on August 1, 1962, are required by the Exchange to maintain a net capital of at least $50,000 or one-twentieth of their aggregate indebtedness, whichever is greater. Introducing firms, numbering 55 on August 1, 1962, are required to maintain a net capital of at least $25,000 or one-twentieth of their aggregate indebtedness, whichever is greater. There were 95 firms, e.g., specialists and floor traders, as of that date, which dealt only with other members and member organizations and which were not subject to the general requirements of the Exchange's net capital rule, though specific capital requirements are applicable to specialists.[77]

Full requirements firms must file three financial questionnaires annually, the dates being arranged so that one is received in each third of the year. Two of the questionnaires may be prepared by the firm without audit. The third must be prepared by an independent public accountant following an audit of the firm's books. Introducing firms must file two financial questionnaires annually, one unaudited and one audited by an independent public accountant. Member organizations not required to meet the minimum capital requirements applicable to other firms are nevertheless required to file two unaudited financial questionnaires annually.

All member organizations are visited on a regular basis by Exchange examiners and are occasionally the subject of special visits on particular problems. The Exchange attempts to have an examiner visit each member organization at least once a year, and for organizations maintaining books and records in more than one office, to examine the accounting records in each such office annually. Examinations are not made, however, of member firm branch offices unless they maintain their own accounting records.[78] During 1961, examiners visited all but 15 full requirements firms and all but 12 of the remaining firms. These 27 firms were visited early in 1962.

In early 1963 the Exchange for the first time initiated a program of examining the books and records of its individual members who are neither partners nor voting stockholders of member organizations. It is expected that following an examination a year after an individual has been a member, inspections will be made once every 3 years.

Each member firm required to file an audited questionnaire must submit annually a prescribed agreement with an independent public

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[76] NYSE rule 325.

[77] See discussion of the NYSE minimum capital rule in ch. II.B.3.a(3). See ch. VI.D.4.c for a discussion of specialist capital requirements.

[78] See discussion of NYSE methods of detection of selling practice violations in ch. III.B.6.b(3)(b). The Exchange instituted a separate program in early 1963 of inspecting branch offices for supervisory and selling practices.

accountant agreeing to an audit at some time during the year.[79] The accountant is required to inform the Exchange of the time of the year in which it expects to make its audit, but the time of the audit is not supposed to be known in advance by the firm.[80] There is little the Exchange can do to police the "surprise" nature of the audit; it must rely on the professional integrity of the accountant. The Exchange does try, however, to see that the accountant does not examine a firm in the same month in successive years. If a pattern of this type appears, the Exchange requests the accountant to change its practice. The Exchange attempts to schedule its own examination of a member firm for a different period from the one in which the independent audit was conducted, and also makes an effort to see that its examiners' visits are not conducted in the same month year after year.

The Exchange does not provide its examiners with a formal checklist for the conduct of a visit to a member firm, on the ground that its examiners should be free to inquire into all aspects of the firm's business to determine compliance with the applicable regulations. Nevertheless certain regular though variable examination routines have developed.

Before an examiner conducts a visit, he may be given special instructions regarding matters which have previously caused difficulties at a particular firm. The first step of the actual examination is a check on the firm's capital condition against its most recent questionnaire. If the answers are based on an audit, the examiner reviews the accountant's working papers to determine whether the audit was conducted in accordance with NYSE requirements. A net capital violation is required to be reported immediately to the Exchange.

After reviewing the examined firm's capital position, the examiner is expected to test check various items such as compliance with Regulation T, margin maintenance requirements, and the segregation of excess margin and fully-paid securities. He is also expected to check for compliance with the Exchange's "know your customer" rule (rule 405) to ascertain whether new account cards with essential information were prepared. Other items which are checked include compliance with Exchange proxy requirements, the prepayment of the proceeds of sale to customers without the charging of interest, and the "philosophy" of the NASD markup policy. At the conclusion of his visit, the examiner reviews his findings with a partner of the firm and prepares a report of his findings for the division of finance, a copy of which is sent to the firm.

Examiners' reports were reviewed by the study covering visits made during October, November, and December 1961, and were found to be of a generally high standard. If problems are raised by the examiner's report, they are followed up by the division of finance or the division of margins in a manner discussed in greater detail below. Ultimately, adverse examiners' reports may result in staff letters urging improvement in performance or in a formal disciplinary proceeding.

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[79] The required agreement is contained in NYSE Guide, par. No. 2418.10. The Exchange requires that each member organization make available to customers requesting it a statement of the firm's financial condition as reflected in its annual audit questionnaire. NYSE rule 419. Such statement need not include the firm's profit or loss for the year.

[80] NYSE rule 418.

(2) *Public complaint procedure*

At the study's public hearings, NYSE President Funston testified that "investigation of complaints is perhaps one of the most direct routes to possible misconduct by registered representatives of member organizations." The review of the Exchange's public complaint procedure in chapter III [81] suggests, however, that investigation of public complaints has been little used by the Exchange as a method of surveillance.

The Exchange's procedure for dealing with public complaints, as described in chapter III, consisted until the spring of 1962 principally of acting as an intermediary in an exchange of correspondence between the complainant and the member firm whose activities were complained of. Upon receipt of a complaint, the Exchange normally forwarded a copy to the firm involved, advising the writer that it would "investigate." When the firm replied, the Exchange sent an abbreviated version of its answer to the complainant for comment. If after further correspondence the complainant was not satisfied, the Exchange ultimately advised him of its arbitration facilities. Independent investigations of the complaints were infrequently undertaken.

In 1961 the Exchange processed approximately 1,200 public complaints in this general manner. A substantial percentage of these complaints and inquiries related to bookkeeping errors, nondelivery of securities, executions, and other matters which could be resolved by referring to books and records. In many of these instances referral of the inquiry to the firm resulted in a voluntary adjustment or transmittal of facts to the Exchange which enabled it to satisfy the complainant. Furthermore, many of the inquiries classified as complaints were essentially aimed at obtaining information. A substantial number of the complaints however, raised questions concerning the conduct of member firms, particularly in the area of selling practices. Such complaints are a particularly useful surveillance device because customers are often in the best position to raise questions of "high pressure" selling, excessive transactions, unsuitable recommendations, and other selling abuses.[82]

One aspect of the Exchange procedure for handling such complaints was that some complainants were not informed of their right to arbitrate until the last letter from the Exchange. If a complainant dropped the matter after receiving one or on occasion two letters from the Exchange, which did not inform him of a right to arbitrate, he was never so informed.[83]

In addition, serious allegations of wrongdoing by members and their salesmen were disposed of by the circulation of correspondence without investigation by the Exchange. An example of the consequences appears in the Exchange's handling of public complaint letters regarding Shearson, Hammill & Co. and its sale of the common stock of USAMCO, described in chapter III.B.6.b(3)(b). This was not an isolated instance. Another complainant alleged, among other things, that his account had been "churned" by a member firm during the year

[81] See ch. III.B.6.b(3)(b). The discussion in this section does not include the handling of public complaints relating to member conduct on the floor. These are treated separately in sec. 4, below.

[82] Ch. III.B.6.b(1)(b) discusses the Commission's handling of complaints received from the public.

[83] Since June 1962, the complainant has been advised of his right to arbitrate in the Exchange's first letter.

1960 in 194 transactions involving a loss to the complainant of $10,150.42 and commissions to the firm of $7,599.88. The Exchange did not even call for a copy of his account from the member firm involved.

Under the procedure in effect in 1961, the firm received a copy of the entire letter sent by the complainant, but the complainant might receive only part of the firm's response, if, as often occurred, the Exchange staff decided to edit the firm's response.[84] An example of the nature of the editing by the staff may be seen in the following paragraph in a letter from the firm to the Exchange:

> This claim had previously been made by Mr. E [customer] in the presence of the writer and several other individuals of this firm. At the time of his complaint, it was determined that there was evident a lack of communication between Mr. E and Mr. F [salesman]. *It was also clear that Mr. F did not know his customer in the manner required by the New York Stock Exchange rules.* On the basis of this conclusion, it was decided that the transactions in Mr. E's account would be adjusted in accordance with his wishes. All the transactions that had taken place in his account prior to his complaint were reviewed with Mr. E, item per item. Where he alleged lack of authorization, adjustments were made. He was specifically asked whether he considered the purchase of 200 shares of Studebaker-Packard was authorized. Mr. E acknowledged that this transaction was authorized and did not wish to have it removed from his account. [Emphasis added.]

When the Exchange wrote to the complainant, it included this paragraph as an excerpt from the firm's statement. The emphasized sentence was omitted, without indication that there had been an omission.

On another occasion, a complainant charged that he had received a poor execution on the purchase of 50 shares of an over-the-counter security at $23 per share. On the date in question the bid prices in the pink sheets of the National Quotation Bureau ranged from a low of 18 to a high of 22 and the asked prices ranged from a low of 22 to a high of 24, and the firm so advised the Exchange, noting that "[t]his record indicates that on September 6 the date of [complainant's] trades, the lowest asked price was 22." The Exchange's reply quoted from the firm's letter, but omitted this sentence. The following appeared in the Exchange's reply, with no indication of an offer of 22 on that date:

> * * * [I]t would not be possible to determine the various prices at which an over-the-counter security sold on any day. However, in a publication, dated September 6, 1960, of the National Daily Quotation Service, which lists bids and offers submitted by parties interested in over-the-counter stocks, [the stock] was quoted at 22 bid, offered at 24. It would, therefore, appear that the price you paid was not inconsistent with the market at the time your purchase was effected.

Many complainants were told by the Exchange that the firm complained about had acted "in good faith" solely on the basis of letters from the firm, without independent investigation of facts relating to the complaint. For example, one complaint concerned a market letter of Florida Palm-Aire Corp. distributed by a firm which enthusiastically recommended the purchase of its common stock, stating:

> of all the land companies that have appeared on the Florida scene, both large and small, Florida Palm-Aire offers a combination of features which in our opinion makes it the most desirable real estate investment currently available.

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[84] This practice was changed in December 1962. The customer now receives a complete copy of the firm's response.

In accordance with the usual procedure, a copy of the complainant's letter to the Exchange was sent to the firm, which replied that the complainant's order was unsolicited, that the facts stated in the market letter were believed to be reliable, and that the market price of the stock was adversely affected by conditions beyond the firm's knowledge or control. The Exchange then wrote to the complainant that:

> in the case at hand there does not appear to be any evidence that [the firm] acted other than in good faith with respect to the Florida Palm-Aire Corp. or made misrepresentations concerning it.

The staff based this conclusion on the letter from the firm; no other investigation was made, nor was the market letter referred to the staff members engaged in reviewing such material. However, when the matter was brought to the attention of the Exchange by the Special Study, the Exchange found the market letter to be in violation of its standards and reprimanded the partner in charge.

The Exchange pattern of handling complaints has evidenced a reluctance to advise members of the public that their claims might have merit. In one instance a complainant alleged that a member firm had promised him an allotment of a new issue which it failed to provide. The firm replied that its salesman had acted without authority. The Exchange, after consulting with counsel, advised the firm of his opinion that the firm might be "hooked," but the complainant was not advised of this opinion.

In 1962 the Exchange initiated various changes in its handling of public complaints, including the creation of a separate unit for processing these complaints with additional personnel. It remains to be seen whether this will result in a departure from the method of handling such complaints described in this subsection.

(3) *Stock watching program*

The Exchange regards its stock watching program as one of its principal methods for detecting violations of its rules and Federal law. Its purpose is to uncover manipulative practices and influences in the exchange market and to keep the Exchange aware of unusual market situations. It is carried on under the supervision of an assistant director of the department of member firms, but involves the joint efforts of that department, the department of stock list, and the floor department.

The stock watching group distributes within the Exchange staff its daily reports, weekly volume reports, monthly short interest reports, and occasional special reports.[85] The weekly volume report is an analysis of the most active stocks during the week; the monthly short interest report is an analysis of the size and changes in short interests. In addition, stock watching keeps approximately 25 to 30 stocks under constant and intensive surveillance because, for example, a company is involved in a proxy contest or if in the opinion of the Exchange staff, "it took on a glamour status."

Because they involve the use of a programmed computer system, the daily reports are of particular interest. At the close of each trading day, the computers of the Stock Clearing Corp. produce a tabulation listing those securities which have exceeded specified price variations,

[85] The floor department, which is responsible for supervising the activities of specialists and floor traders, sometimes orders a special market study of trading in a particular stock.

either during the course of the trading day or from the previous day's close. These price variations are contained in two schedules, one of which is used on normal trading days and the other of which is used, at least in part, on unusual trading days.[86]

The daily tabulation, which includes all listed securities which have exceeded the specified variations, is available early in the next morning. The Exchange staff then attempts to ascertain reasons for any unusual price movements it discloses. The price change may be attributable to general market conditions, specific industry conditions, earnings reports, advisory service recommendations, newspaper articles, rumors of good or bad news, new products, or any one of several other reasons. In attempting to pinpoint the reason for these price movements, the staff reviews newspapers, advisory services, and market letters. If necessary, the department of stock list, which maintains liaison with listed companies, may contact the company.

The daily stock watching report lists each company which had exceeded its programed variation for the previous day, the amount of the variation, and an explanation for the price change. The following examples of the types of explanations given are taken from the report for October 9, 1961:

CERTAIN-TEED PRODUCTS 67, up 3½ Volume 15,200 shares	Stock still benefiting from higher earnings and proposal by management that directors should declare a 25-percent stock dividend and maintain the $0.15 quarterly rate on the new stock. This was announced by president at a meeting of New York Society of Security Analysts on October 5.
FAIRMONT FOODS 35⅝, up 2⅛ Volume 15,700 shares	Wall Street Journal reports an investment advisory service recommended this stock. Preferred stock recently called for redemption.
HONOLULU OIL 84⅜, up 4 Volume 10,000 shares	Stock advanced after company said it had received tax rulings from IRS that Honolulu says will let it sell its assets to several other oil concerns.
IDAHO POWER 38⅜, up 2¼ Volume 1,400 shares	On September 29 company announced earnings for 12 months ended July 31, 1961, were at $1.46 a share versus $1.29.

In many instances the staff is unable to develop any reason for the price advance or decline by the time the stock watching report is submitted, which is generally the end of the following trading day. In such cases, it must decide whether to make further inquiry. If the security is in one of the so-called glamour industries, is involved in a proxy fight, has high volume, or is generally known as a "problem" stock, it may be subject to additional investigation. Even where an explanation is given in a stock watching report, such as the issuance of a market letter, the staff may still continue its investigation.

The first step in any of these investigations is to call for the stock clearing sheets, which show the clearing firms on both sides of trans-

[86] Each security is not programmed separately based on its past performance, but all securities in the same price class are lumped together. For example, for any stock in the price range of 40 to 59⅞, schedule I (used on normal trading days) provides for a variation of 2½ points before the stock is included on the tabulation. Schedule II (used on unusual trading days) permits a variation of 3 points in the same stock.

actions in the stock.[87] These sheets are checked for concentrations of buying or selling. Unless special circumstances are present, the inquiry is not pressed if no concentration is found. Where concentration is found, the firms involved are asked to supply details as to transactions and customers. Concentration in a branch office or among the customers of a particular registered representative is of special interest. Employees and customers of a firm may be interviewed during an investigation. Facts uncovered by these investigations are reported on the stock watching reports, and when manipulative activities are uncovered, as has occurred on various occasions, the Commission is advised.[88]

The stock watching program is a significant development in market surveillance. Through the use of computers, the ability to maintain supervision over market developments is considerably increased. The potential value of stock watching was recently demonstrated in connection with a disciplinary action taken by the Exchange against an allied member who had purchased in his wife's name 5,000 shares of stock in a company of which he was a director, after having learned of a proposed offer of tender for the stock by another company. The shares were purchased before the company's board voted to endorse the offer and before the matter became public. Stock watching detected the 5,000 share purchase; the allied member was questioned by the staff, fined $1,000, and the purchase was canceled.

b. Enforcement activities

(1) *Enforcement of the net capital rule*

The net capital rule (rule 325)[89] is regarded by the Exchange as the most important rule administered by the department of member firms. The principal methods for detecting violations are through the system of financial questionnaires, audits by independent public accountants, and visits by Exchange examiners, which were described above in section 3.a(1). The division of finance of the department is principally responsible for supervising the capital condition of member firms, and in performing this function it reviews examiners' reports and analyses of financial condition prepared by the examiners upon receipt of financial questionnairies.

The net capital rule requires that a member organization promptly notify the Exchange if its net capital does not equal or exceed the requirements.[90] It is the only Exchange rule as to which a member firm is required to report its own violation; several firms have done so in recent years. If a firm fails to report its violations, the Exchange has a basis for imposing severe disciplinary sanctions.

The authority of the staff to dispose of net capital violations is limited. In general, net capital violations are reported to the advisory committee or the board of governors for disciplinary action unless the violation is a minor one by a new introducing firm, or unless a new full requirements firm has misinterpreted a rule and the violation is minor. Any decision not to refer a net capital violation to the advisory committee or the board of governors must first be

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[87] During the period in which a stock is being investigated, it continues to appear on the daily stock watching reports.

[88] The Exchange does not have subpena power and consequently may be unable to pursue its investigation to individuals outside of its community.

[89] See ch. II.B.3 and ch. III.D for discussions of financial responsibility of broker-dealers.

[90] NYSE rule 325.

cleared with the vice president in charge of the department. The 17 violations handled at the staff level during the period from January 1959 through August 1962 appear to be technical in nature, involving such questions as the consideration to be given to the capital contribution of a deceased limited partner, the treatment to be accorded to the market value of securities located in partners' accounts, and the method of treating transactions with affiliates.

While its disciplinary authority in this area is limited, the staff exercises considerable initiative in making "suggestons" concerning their capital to firms which are coming precariously close to violating the net capital rule. In such cases the staff may "suggest" that the firm increase its minimum requirement by a specified amount, for example, from $50,000 to $75,000, or that its aggregate indebtedness not exceed 1,750 percent of net capital instead of the generally permissible 2,000 percent. In addition, chapter III.D.3.d describes standards generally applied by the staff to keep firms' inventories from becoming excessive. The staff's suggestions are generally adopted by the firms, but the staff cannot bring a disciplinary action for a violation of a staff-imposed standard. However, if the advisory committee or the board of governors adopts the staff suggestion, the firm is bound to adhere to the higher figure, and a failure to do so will result in a net capital violation.[91]

If a firm has either violated the net capital requirements or is close to doing so, the staff may also require the firm to submit weekly net capital computations and in some instances, daily securities positions, until the firm has satisfied the staff that its capital problem is under control. If the size of positions in the firm's inventory is presenting difficulties, the staff may suggest to the firm that it liquidate part or all of these positions. In the alternative, the staff may ascribe little value for net capital purposes to a large position in order to encourage liquidation of part or all of that position.

During the period from January 1, 1957, through September 30, 1962, 33 net capital cases, involving 29 member firms, were considered by the advisory committee or the board of governors out of a total of 66 separate disciplinary cases. Thus, 50 percent of all formal Exchange disciplinary cases involved net capital violations. This is an indication of the importance of the net capital rule in the Exchange's view, and the effort which it expends in policing the rule.

Of the 33 instances of net capital violations, 2 resulted in admonitions, 8 in censures, 14 in severe censures, 7 in fines and severe censures, 1 in a suspension, and 1 in an expulsion. It is evident that admonitions and censures, including "severe" censures, are the most frequently used sanction, and that the Exchange considers them effective.[92] The fines imposed in the seven cases ranged from $250 in one to a total of $15,000 in another case.

The enforcement by the Exchange of its net capital rule should be the standard by which other aspects of its regulatory program are judged. The staff vigorously seeks out violations and they are processed swiftly and fairly.

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[91] NYSE rule 325 gives the Exchange power to prescribe stricter requirements for a member organization than those specified in the rule.

[92] An exchange vice president testified that the distinction between admonitions, censures, and severe censures served an "historical function."

(2) *Enforcement of credit regulations*

The Exchange has important responsibilities in the enforcement of credit regulations.[93] It enforces the margin and prompt payment requirements of Regulation T and its own margin maintenance requirements.[94] Its activities in this area are especially important because, as indicated in study questionnaire OTC-3, more than 98 percent of total debit balances in margin accounts of all registered broker-dealers were carried by NYSE member firms on January 30, 1962.[95]

The Exchange performs a valuable role in the dissemination of information regarding credit regulation. Its division of margins maintains close liaison with the Federal Reserve Board and interprets these complex regulations when asked for an opinion by member firms. The Exchange also publishes educational circulars on the subject.

The prompt payment requirements of Regulation T specify that a customer must pay for securities purchased in cash accounts within 7 business days, and must meet the currently applicable margin requirements within 4 days from the purchase date, unless an extension of time is obtained. Regulation T permits extensions of time in "exceptional circumstances." During the first 11 months of 1962 almost 375,000 requests were received; of these, approximately 140,000 were marked as "final" extensions and 400 were denied.

Certain of the extension requests are checked by the staff to detect excessive patterns of requests by particular customers. No inquiry is made into the good faith of the firms in the routine processing of requests, but Exchange examiners during their visits spot check compliance with the prompt payment requirements. They found apparent violations of these requirements in approximately 15 percent of the firms visited in October-December 1961. In addition, among other matters, Exchange examiners spot check transactions in restricted accounts, the purchase and sale of securities with inadequate margin, the failure to make margin calls when necessary, and the liquidation of accounts in which equities have fallen below Exchange maintenance requirements. They also seek to determine whether nonpurpose loans have been granted by member firms which have the effect of evading Regulations T and U, and whether credit has been "arranged" by the firm for customers on better terms than the firm could lend.[96]

The Exchange makes widespread use of its informal disciplinary procedure in handling credit violations uncovered by examiners' visits. Generally, a violating firm is advised by letter of the examiner's findings—the matter is infrequently referred to the advisory committee or the board of governors. This was true, for example, in an instance where an examiner found "flagrant violations" of Regulation T in customers' margin accounts; that margin calls had not been made or extensions applied for; that no daily call record had been maintained; that margins were provided by liquidation; and that sales of over-the-counter securities were made in margin accounts without giving consideration to the effects of Regulation T.

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[93] See ch. X.C for a discussion of the substantive requirements in this area.
[94] NYSE rule 431.
[95] See table X-1.
[96] For a discussion by the Commission of the application of sec. 7(a) of Regulation T, dealing with the "arrangement" of credit by broker-dealers, see Sutro Bros. & Co., Securities Exchange Act release No. 7052 (Apr. 10, 1963).

No credit cases arising under either Regulation T or the Exchange's own margin maintenance requirements were referred to the advisory committee or the board of governors during the years 1957–60. Eight such cases were decided from January 1, 1961, through September 30, 1962. Two involved the filing of false financial statements where the members had obtained nonpurpose loans in contravention of Regulation T or U, while a third involved violations of Regulation T in obtaining a nonpurpose loan purportedly for the purchase land, whereas the proceeds were actually used to buy unlisted securities. In a fourth case, a member was found to have violated Regulation T in making arrangements for his own and wife's accounts with an unregulated lender. Substantial penalties were imposed in these four cases, ranging from the severe censure and $5,000 fine in one to a 5-year suspension in another.

There were also four disciplinary cases brought during the period for violations of Regulation T and the margin maintenance requirements occurring in the accounts of customers of member firms. Generally, the violations reflected a breakdown of the firm's supervisory procedures. The penalties ranged from severe censure to a fine of $2,500.

(3) *Supervision over selling practices of member organizations*

The extent to which the Exchange has utilized its surveillance procedures to supervise selling practices of member organizations has been described in chapter III.B.6.b(3).[97] Although the Exchange takes the position that the quality and effectiveness of supervision and control over persons selling securities depend, for the most part, upon the individual member organizations, it does make some use of public complaints, visits by Exchange examiners, and stock watching as controls in this area. However, as noted in chapter III, these techniques have proven to be inadequate to cope with the problem of supervising selling practices. It is difficult to detect selling abuses, except for churning, by an examination of books and records at a firm's main office. Furthermore, the examiners do not talk to registered representatives, examine sales literature, review public complaint files, or particularly concern themselves with the methods by which securities are sold. Similarly, the stock watching program is principally directed at finding manipulations and other market irregularities, and only incidentally at finding selling practice abuses. The inadequate utilization of the public complaint procedure, which is the best of these methods for detecting selling abuses, has been discussed above.

Chapter III also describes the branch office visits by members of the staff of the department of member firms to observe office decorum and branch office atmosphere, and various surveys and studies of selling practices undertaken by the Exchange since 1955, and the Exchange conclusion from them that random-sample interviews were less effective as a control than specific case studies. It notes the new Exchange program of branch office inspections to be inaugurated in 1963 under which Exchange examiners will visit branch offices, on a 3- to 4-year cycle, to check on the supervisory procedures and selling practices of member firms, and the recent distribution of a manual to member firms

[97] For a discussion of the Commission's surveillance and enforcement program as to selling practices, see ch. III.B.6.b(1).

on the supervision and management of registered representatives and customers' accounts.

Since the Exchange's principal surveillance techniques are not aimed at the detection of improper selling practices, it is not surprising that few of the disciplinary cases involving members, allied members, or member organizations brought by the Exchange have been related to selling practices. Of the 66 member and member firm cases decided between January 1, 1957, and September 30, 1962, only 6 involved the so-called "know your customer" rule, the Exchange's closest equivalent of the NASD suitability rule.[98] In four of the six cases the firms had dealt with unregulated lenders on a large scale. The other two involved situations where nonmembers were using the facilities of member firms for unlawful purposes.

There was only one case during this period in which partners of a member firm were disciplined in a situation involving selling abuses. In this case, an active customer of the firm gave cash, stock, and options to several salesmen to compensate them for selling stock in a uranium company which the customer was promoting. Public sale of the stock was subsequently enjoined because of violations of the Securities Act. The salesmen testified before the Exchange staff that the customer told them the partners of the firm approved of what they were doing. The registered representatives involved were given penalties by the Exchange ranging up to 6 months' suspension, and the Exchange also brought proceedings against two partners of the firm for failure to supervise its salesmen properly. In reporting the matter to the advisory committee, the staff did not inform the committee of the fact that options and stock in the company had been acquired by partners of the firm or of the fact that the firm had made a market in the stock. One partner of the firm was censured and one was admonished.

Despite the fact that almost 400 salesmen were disciplined by the Exchange in the 1957–62 period, the only Exchange action based upon a failure to supervise salesmen properly was the proceeding just mentioned, although evidence of failure to supervise properly was present in several of these cases. For example, a salesman of one member firm was censured for violation of the "know your customer" rule in a case in which the suitability of recommendations was at issue.[99] The salesman was censured by the Exchange for violating the rule. In his defense he stated that one of the two accounts involved was not exclusively his, and that the firm's senior partner "personally handled the account in addition to myself." The Exchange did not investigate the partner's participation in the handling of the account, nor did it act against the firm for failure to supervise properly.

Recent efforts undertaken by the Exchange indicate that greater concern is being given selling practice supervision. The branch office inspection program which has been instituted and the Exchange's disposition of the case involving Bache & Co.'s Seattle branch office[100] reflect increased attention to the supervisory practices of member

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[98] NASD rules of fair practice, art. III, sec. 2. For a discussion of this rule, see ch. III.B.6.b(2)(a).

[99] This was the only case during the 1957–62 period in which the lack of suitability of recommendations was charged.

[100] See ch. III.B.5.b.

firms. Although it is too early to judge the impact of this new emphasis, it is hoped that more effective sales supervision will result.

(4) *Market letter and sales literature review*

Since November 1, 1955, the Exchange has required that market letters and sales literature prepared and issued by member organizations for general distribution to the public be approved by a member, general partner, or officer who is a voting stockholder,[101] and that member organizations retain for at least 3 years all market letters and sales literature which refer to the market generally or to specific listed or unlisted companies or securities.[102]

These rules form the basis of the Exchange's review of market letters and sales literature which was described in chapter III.C.8.a(2).[103] As there noted, the review is vested in the branch of public relations and market development, which principally performs nonregulatory functions. Until recently, the market letter and sales literature review program was administered by the same personnel responsible for Exchange advertising and promotional activities and for advising member firms on their advertising programs. However, the Exchange recently established a separate unit of advertising and market letter review.

The Exchange has sharply increased its review of market letters and sales literature in recent months, and the personnel engaged in market letter review has been increased. The Exchange's standards for reviewing market letters and sales literature are also described in chapter III.C.8.a(2). In general, staff criticism of specific market letters and sales literature relates to statements which are considered to be too promissory in tone or which are not properly qualified. Under these circumstances, the staff communicates its views to the firm involved or may institute a disciplinary case by referring the matter to the advisory committee or the board of governors. However, the latter course is rarely used. Until the end of 1962, only one case had been referred for formal disciplinary action.

Typical of the more serious situations in which the staff has found violations of Exchange standards which it disposed of without reference to the advisory committee or the board of governors is the following: A member firm issued an undated market letter in early 1962, enthusiastically recommending the purchase of an over-the-counter stock. The report contained such expressions as "real bonanza," "unique position," "tremendous increase," and "hailed by the press as one of the most revolutionary developments." The Exchange staff determined that statements of the company's future prospects were not properly qualified, adequate financial information was not presented, the report contained numerous exaggerations, used flamboyant language, contained several misleading statements, and failed to mention the risks involved. It also found that the firm had underwritten an

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[101] NYSE rule 472.

[102] Ibid. NYSE Guide, par. 2472.10, defines "market letter" as any publication, printed or processed, which comments on the securities markets or individual securities and is prepared for general distribution to the organization's customers or to the public. The term "sales literature" is defined as printed or processed reports or analyses covering individual companies or industries; leaflets or booklets interpreting the facilities offered by a member organization or its personnel to the public; discussions of the place of investment in an individual's financial planning; and to printed or processed material calling attention to any of the foregoing, which is prepared for and given general distribution.

[103] The Commission's efforts in the area of regulating investment advice are described in ch. III.C.8.a(1).

offering of the particular stock in October 1961, held options to purchase approximately 3,200 shares, and was making a market in the stock. The staff concluded that its own censure of the firm was an adequate disciplinary sanction.

In another situation, the Exchange staff reviewed a market letter distributed in 1959 by a member firm regarding an over-the-counter stock. The report was undated and indicated neither the stock's most recent price or where it was traded. It stated that "the individual forward-looking investor" can "hitch his wagon to a star, in the stock of one of the more promising electronics equities—[name of the stock]." The report concluded with the following:

> Recommendation: Man, in his speculative thinking no longer is earthbound. The limitless universe is his range. This relatively new science of electronics, as a consequence, offers the individual investor an extraordinary opportunity to reap substantial capital gains.

The staff, in reviewing the report, found many violations of Exchange standards, and advised a partner of the firm orally of these. No other action was taken.

In still another case, the staff found a series of market reports distributed by a member firm to be full of exaggerations, flamboyant statements, and tips and rumors. One of the reports passed on a rumor that an NYSE stock, then selling at 13, was "a $100 stock of the future." Although not endorsing this appraisal, the report described it as a "vast industrial empire" with "fabulous possibilities." Similarly another stock, which started on the Amex "with a dynamic rush," was stated to be "about ready to start going again, almost immediately" and "will move fast and far when it does." Exchange staff members spoke to an officer of the firm and the writer of the report.

It is not suggested that disciplinary proceedings were called for in any of the above instances, but it would seem that the Exchange should have acted more forcefully by admonishing its individual member firms not to add to the prevailing speculative climate—a warning which the NYSE did give the public—by the content and tone of their market letters, and then invoking severe descipline against any firm that circulated inflammatory market reports.

The one market letter case which the branch of public relations referred to the Advisory Committee involved an unfavorable report on a listed company. An analyst with a member firm prepared a memorandum on the company for his firm's research department after a visit with corporate officials. A copy was given to each of two institutional investors, and the report was the basis for discussions with six other institutional holders of the stock. In a letter to the president of the Exchange the president of the company objected vigorously to what he described as "untruths, half-truths, and false conclusions" appearing in this memorandum. After a meeting among representatives of the company, the firm, and the Exchange, a new memorandum was distributed by the firm which conceded that "regrettable errors" had been made in the first memorandum.

In his testimony before the Exchange staff, the analyst took the position that the changes made in the second memorandum were dictated by company representatives and stood by his position that the stock was one to sell. The staff referred this matter to the advisory

committee and a partner of the firm was severely censured for his failure to supervise properly. The analyst's registration as a registered representative was suspended for 1 month.

The market letter distributed by Stearns & Co. and prepared by Walter Gutman, a registered representative and analyst with that firm, which is discussed in chapter III.C. 7 and 8, revealed a serious shortcoming in the market review program. As indicated in that chapter, although the Gutman letter was under constant surveillance by the Exchange, the surveillance related principally to "good taste," and not to the recommendations themselves and the trading surrounding the recommendations. In June and August 1962 the Exchange conducted its first systematic checks of member firms as to trading by employees and partners against firm market letters, and it has advised the study that it will have a continuing program in this area.

Testimony given by NYSE staff officials in late 1962 revealed that, although the Exchange encouraged its members to advertise the quality of their research services, it had no program to determine the standards and qualifications of their research departments. However, the Exchange apparently altered its practice early in 1963. In an educational circular in March 1963, the Exchange condemned as "exaggerated" a statement in a member firm's advertisement that the firm had "complete research service," whereas its research staff consisted of one analyst who, with a part-time assistant, prepared market letters and research reports, provided information to 40 salesmen, and handled 45 of his own accounts.[104]

(5) *Advertising review*

The Exchange requires that members and member organizations submit all advertisements for approval before publication.[105] It also requires that the text of all commercials and program material sponsored by member firms (except lists of market quotations) about securities on radio or television must be sent to the Exchange promptly after the program.[106] The standards governing advertising, radio, and television programs are identical to the standards for market letters and sales literature. It should be noted that all advertisements are reviewed by the Exchange, whereas market letters are spot checked.

The Special Study staff examined advertisements submitted by 39 member organizations to the Exchange during the period from January 1, 1959, through August 1, 1962. Exchange officials estimate that approximately 6,000 advertisements are submitted annually and that changes of one kind or another are made in approximately 25 percent of these advertisements.

The Exchange's efforts in reviewing advertisements are principally devoted to toning down material which is overly promissory or which does not properly qualify statements. The types of changes suggested by the staff which are aimed at toning down copy are illustrated by

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[104] P.R. and M.D. Educational Circular No. 3, Mar. 29, 1963.

[105] Exchange rule 471. NYSE Guide, par. No. 2471.10, also provides that routine advertisements in a general form previously approved, including business cards, announcements that specific unlisted securities are bought, sold, and quoted, announcements of dissolution, approved firm or corporation formations, approved new offices, partnership or stockholders changes, or employment of registered representatives, need not be submitted to the Exchange in advance.

[106] NYSE rule 473.

the following examples, in which underlined words were deleted and bracketed words substituted or added:

> The decade ahead will [should] be a period of above-average growth for this industry.
>
> A minimum of $900 billion will [is expected to] be spent * * *.
>
> Even with very long range objectives, investors want to know when will [is] the market [likely to] go up.
>
> Companies that are focused upon the development and application of brain-power, rather than extractive operations, are likely [in our opinion] to continue to prove the most swiftly advancing activities in the years ahead.
>
> Unique [excellent] opportunity.

In general, the efforts of the Exchange's advertising review program have been effective in restraining flamboyant advertising.

Advertising review is subject to the same limitations as market letter review in that the staff does not inquire into statements made regarding the qualifications, facilities, or services offered by member firms.[107] When questioned about an advertisement approved by the Exchange which indicated that a member firm offered "financial estate planning," an Exchange staff member testified:

> Q. Well, would a statement that a firm does financial estate planning be acceptable where it is submitted by any member firm of the Exchange, or are you specifically referring to [the member firm]?
>
> A. I am referring to this particular ad, and the way it is handled.
>
> * * * * * * *
>
> Q. And is that in some way based upon your knowledge of the operations of that firm?
>
> A. No.

(6) *Segregation, hypothecation, and lending of securities*

Exchange rules relating to segregation, hypothecation, and lending of securities are described in detail in chapter III.D.3. Briefly, they provide that no security held by a member firm for the account of a customer, either fully paid or representing excess margin, may be lent to the firm itself as a broker or to others, or may be delivered on sales made by the member firm for any account in which the firm or a partner or officer is interested unless a specific written agreement designating the particular securities to be lent is first obtained from the customer.[108] No agreement to pledge securities carried for the account of a customer justifies the member firm in pledging or lending more of the securities than is "fair and reasonable" in view of the customer's debt to the firm.[109] The Exchange has indicated as acceptable certain methods of segregating wholly owned and excess margin securities.[110]

The rules relating to segregation, hypothecation, and lending of securities are closely interrelated. Segregation of securities is a means of physically safeguarding securities held in the custody of firms, of identifying the ownership of securities, and of administering the hypothecation and lending rules.

Exchange examiners check on the segregation of wholly owned and excess margin securities on their regular visits to member firms. In the course of 201 examinations made during the months of October,

[107] But see recent P.R. and M.D. Educational Circular No. 3, Mar. 29, 1963, which indicates a new policy and in this regard has been adopted by the Exchange.
[108] NYSE rule 402(d).
[109] NYSE rule 402(a).
[110] NYSE Guide, par. No. 2402.10–2402.90.

November, and December, 1961, violations of the rule were discovered at 12 firms. In those cases the examiner normally advised the partner in charge to segregate immediately the securities involved, and the Exchange wrote a letter to the firm asking for assurance that no further violations would take place. The principal thrust of the Exchange's enforcement activities is directed at persuasion and improvement of the internal mechanisms of the firms and not toward disciplinary action. Exchange officials testified that they could not recall any "serious cases" in this area—and no cases involving this rule were referred to the advisory committee or the board of governors during 1957–62.

The emphasis on persuasion and education can be illustrated with the example of an examiner's visit to a member firm in November 1961, which revealed "many instances" of failure to segregate properly free and excess margin securities. When the matter was called to the firm's attention, 336,570 shares of various securities were ordered into segregation. The same visit also revealed, among other things, "excess net capital [of] only $81,600," a number of accounts which were undermargined, violations of Regulation T and rule 432(a), and a "great number of deficiencies which have existed for a substantial period of time." [111] After receipt of the examiner's report, members of the Exchange staff promptly held a number of meetings with the firm at which corrective measures were discussed, and the Exchange thereafter maintained close supervision over the firm's capital position and the deficiencies disclosed by the report. A subsequent visit by an Exchange examiner in October 1962 indicated that the firm was in compliance with the segregation, Regulation T, and margin requirements.

(7) *Regulation of non-Exchange activities*

The Exchange takes the position that members are responsible to it for the conduct of their affairs in all aspects of their operations.[112] As a practical matter, although the Exchange has assumed a measure of responsibility with respect to the over-the-counter activities of its members, it has not attempted to promulgate rules or define standards of conduct applicable to the full scope of its members' over-the-counter business as such, except to prohibit generally engaging in over-the-counter transactions in Exchange-listed securities. Although its members are very important participants in over-the-counter markets, they are in competition with all nonmembers in those markets, and this obviously limits the potential scope of Exchange regulation in this area.

There are many situations in which over-the-counter and Exchange transactions are joined together in a single set of circumstances. In those instances, the Exchange treats the transactions as a unit. For example, if an Exchange examiner detects violations of Regulation T in both over-the-counter and Exchange securities, the infractions are handled together. The same is true with regard to the review of mar-

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[111] A review of the firm's financial reports to the Commission, also received by the Exchange, indicates this was not a situation which arose over a short period of time. The report as of Dec. 31, 1959, for example, indicated that $11,646,634 in free securities were not segregated. The report as of Dec. 31, 1960, showed that $3,086,338 in free securities were not segregated, while the one as of Dec. 31, 1961, revealed unsegregated free securities of $8,277,834 and unsegregated excess collateral of $12,373,888.

[112] Hearings before a subcommittee of the House Committee on Interstate and Foreign Commerce on H.J. Res. 438, 87th Cong., 1st sess., p. 108 (1961).

ket letters, sales literature, and advertising, in which the copy may refer to both Exchange and over-the-counter securities.

The Exchange took an active role in at least one over-the-counter problem area: underwriters' compensation. Its activities in this regard stemmed from a concern over offerings of low-priced, speculative issues of relatively small, unknown companies in which the compensation appeared excessive. Starting in 1959, the Exchange attempted to determine what constituted "reasonable" compensation, and consulted with various industry groups to find a yardstick. In December 1961 it issued an educational circular to its members on the subject of underwriting low-priced speculative issues.[113] Shortly thereafter, the staff orally advised 104 active underwriting firms that the Exchange normally considered compensation of 20 percent of the aggregate public offering price as the outside limit for underwriting compensation and expenses, unless individual circumstances of a particular offering justified higher levels, and that options or warrants to acquire the offered security must be at a price at or above the public offering price, and should be in an amount bearing a reasonable relation to the company's capitalization. The Exchange was the first industry group to establish standards and review procedures in this regard; its activities were a factor in increased industry supervision in this area. In 1963 the Exchange stated that it expected to discontinue its review of underwriters' compensation on the ground that it involved an unnecessary duplication of the NASD program.[114]

Exchange examiners are also expected to test check as to whether firms are complying with the "philosophy" of the NASD markup policy in connection with their over-the-counter transactions. Exchange officials could recall no instance in which member firms had not complied with the philosophy of this policy during the last 5 years. As a matter of course, Exchange examiners do not concern themselves with the "free-riding and withholding" interpretation of the NASD.

c. *Disciplinary procedures and actions involving members, allied members, and member organizations*

(1) *Procedures*

The description of Exchange staff enforcement activities involving member and allied member activities off the floor demonstrates that the enforcement procedures frequently involve an exercise of judgment as to whether actual disciplinary proceedings should be instituted. A substantial number of situations which involve infractions of Exchange rules or failure to maintain Exchange standards are disposed of completely on the staff level, without reaching the status of a formal disciplinary proceeding. Informal staff activities thus form a significant portion of Exchange discipline of its members; indeed the question arises whether in disciplining members for off-floor activities the Exchange may not on occasion rely too heavily on staff action to the extent that it disposes summarily of matters warranting more serious action. The Department of Member Firms, which is principally responsible for the regulation of the conduct of members and their organizations off the floor of the Exchange, is directly involved in the disciplinary machinery from the outset until a decision is rendered and a penalty fixed. When the department's staff believes a vio-

[113] Member Firm Educational Circular No. 152, Dec. 26, 1961.
[114] For a discussion of the NASD program, see pt. G.5.b(3), below. Also see pt. J, below, for a discussion of the coordination of regulatory efforts.

lation of Exchange rules or Federal law has occurred, it is empowered to call any individual connected with the member organization involved for information, and can require any member, allied member, limited partner, or employee to be present at a formal hearing and to produce books and records. By tradition, a member or allied member who is questioned by the staff is entitled to have a governor present, but the right is rarely exercised and not always mentioned to him. He is not entitled to have counsel present.

Once the staff has gathered sufficient evidence to satisfy itself that a violation has taken place, it may decide that the violation is of such gravity as to warrant referral to the board. If the violation is not of such a serious nature, the staff may refer it to the advisory committee or handle it entirely on the staff level.

In cases other than those involving a violation of the Exchange's net capital rule, the staff has considerable discretion in deciding whether referral to either the advisory committee or the board should be made. For example, the staff frequently disposes of violations of Regulation T, the Exchange's margin maintenance requirements, the proxy solicitation rules, or the requirements as to the segregation of free and excess margin securities, by sending a letter warning that future violations may result in more serious disciplinary action. On occasion a warning is administered at a staff hearing and is followed by a letter. In any such case, the Exchange's formal disciplinary machinery is not involved and the results are not reported to the Commission.

If a net capital violation is involved, Exchange policy requires that the matter be referred either to the advisory committee or the board of governors except in limited circumstances.[115] When a case is to be referred to the advisory committee, the staff prepares a memorandum of the facts as it has determined them, together with a statement of the problems presented. After approval by the president and executive vice president, the memorandum is mailed to the member or member organization involved. The member or member organization is given an opportunity to explain, amplify, or contradict the facts presented by the staff. The staff memorandum and the firm's response are submitted to the advisory committee, which determines by a majority vote of those present whether there has been a violation and, if so, what penalty should be imposed. The member or partner involved does not appear at the meeting, but is given the opportunity to attend a subsequent meeting to make an additional explanation. The committee generally asks the staff, which attends the meeting, to comment on the appropriateness of the penalty in light of the particular facts and previous decisions.

The advisory committee reports all of its actions to the board of governors. According to the vice president in charge of the department of member firms, the board has never reversed or modified an advisory committee disciplinary decision on its own motion.

While the staff has more discretion in referring cases of certain types to the advisory committee, the procedures followed in its proceedings are the same for charges of any type. A full proceeding before the board, however, involves a more complex and formal routine.

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[115] See sec. b(1), above.

If the staff believes that the alleged violation is serious enough to warrant charges before the board, the case must first be reviewed by the informal committee, consisting of the chairman, vice chairman, and president. If the informal committee believes that charges before the board are warranted, the board adopts a resolution calling for a hearing on a specified date and directing the secretary of the Exchange to notify the member or partner involved of the procedure to be followed. A member is entitled to be served with charges in reasonable detail. At the hearing before the board, the member or allied member may present testimony and cross examine the witnesses presented by the staff. He is not, however, entitled to be represented by counsel.[116] An Exchange vice president testified with regard to the policy of excluding counsel:

> It has been our custom. We think it works. We think it is fair. We think that it accomplishes results. I find no fault with it.

After the case has been heard, the board votes on separate motions on whether the member or allied member is guilty of the offense charged and, if guilty, on the penalty to be imposed. Where a majority vote (17) of the governors then in office finds the member or allied member guilty of fraud or fraudulent acts, he must be expelled. For other violations of the Exchange's constitution and rules, the board has the power to impose the penalties of censure, fine (not exceeding $5,000), suspension, or expulsion. In order to censure, fine, or suspend a member or allied member for any offense, a vote of a majority of the governors then in office is required. In order to expel him for reasons other than fraud, a vote of two-thirds (22) of the governors then in office is required.[117]

The board of governors and the advisory committee do not make findings of fact or issue opinions in connection with disciplinary cases. They simply decide whether the member or allied member is guilty of the specific matters charged and, if so, impose a penalty.

(2) *Staff disposition of violations*

The Exchange staff can dispose of rule violations at its level in certain limited types of net capital violations generally involving new firms and violations which are somewhat technical in nature, and more commonly in cases of infractions of Regulation T and the Exchange's margin maintenance requirements. Other types of violations frequently handled in this manner include violations of the Exchange's rule on segregating fully paid and excess margin securities (rule 402), and its proxy solicitation rules (rules 450–456), as well as violations of Exchange standards in market letters, sales literature, and advertising material.

During the year 1961, 83 firms violated Regulation T of the Federal Reserve Board without the matter being referred to the advisory committee or the board of governors. Of these 83 firms, 18 had numerous violations. Eleven of these explained the violations to the satisfaction of the staff, while others were sent a letter by the staff warning that future violations might be the subject of a report to the advisory committee. During the same period seven firms violated the Exchange's

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[116] NYSE constitution, art. XIV, sec. 21. See art. XIV generally for procedures in disciplinary cases.
[117] NYSE constitution, art. XIV, secs. 1, 12, 13.

margin maintenance requirements, but satisfied the staff that the infractions were minor.

The extent to which the Exchange goes in handling off-floor violations on this basis is illustrated by a series of incidents involving one of the larger member firms. The firm had a history of violations of Regulation T and the margin maintenance requirements in 1956 and 1957. In each case the firm was warned by the Exchange about future violations. An examiner's report filed on December 31, 1958, disclosed, among other violations: instances in which customers' short accounts were below the Exchange's margin maintenance requirements; customers permitted to withdraw cash from at least two accounts that were below the maintenance requirements; margin calls repeatedly met by liquidation of securities; failures to request necessary extensions of time; repeated requests for extensions giving identical reasons; partner participation in a joint account found to have been in a deficit margin condition for a long period of time; delivery of securities "free" before payment; and failure to keep proper records of the manner in which margin calls were answered. In summarizing the situation, the manager of the Exchange's division of margins commented: "It shows a complete laxity on the part of the firm's management in allowing such a gross condition to continue unchecked." Nevertheless the matter was not referred to the advisory committee, and the violations were disposed of by means of an oral reprimand delivered to two partners in March 1959.

An examiner's visit to the firm in July 1961 again disclosed Regulation T and margin problems. He reported 5 accounts with approximately 25 occasions in which payment for securities was met by liquidation and 14 accounts with approximately 26 instances of unapproved grants of extensions of time in violation of Regulation T. Only 5 extensions were located in connection with 38 late payments, 4 of which made payment after the extension expired, and 3 extensions carried improper dates. Nevertheless, the matter was disposed of by means of a staff letter to the firm stating that the situation appeared to amount to a "breakdown" in the margin department and that in the case of a future violation a report might be made to the advisory committee.

The disposition of violations in this manner is not reported to the Commission and makes more difficult its task of supervising the Exchange's self-regulatory program. Without information on the staff disposition of violations, the Commission is without the essential facts to judge the manner in which the Exchange is meeting its regulatory responsibilities.

(3) *Formal actions*

During the 5¾-year period from January 1, 1957, through September 30, 1962, 66 formal disciplinary cases were decided by the advisory committee and the board of governors. They break down by subject matter as follows:

Net capital	33	Market letters	2
Regulation T and margin maintenance	8	Federal income tax problems	2
"Know your customer"	6	Selling practices	1
Floor violations	5	Miscellaneous	5
Fraud	2		
Minimum commission schedule	2	Total	66

These figures emphasize the importance in the Exchange's regulatory activities of the enforcement of its net capital requirements, in which the interests of the members and of the investing public in the sound financial condition of member firms are identical. At the other end of the scale, it is noteworthy that only one case during the period involved improper selling practices,[118] reflecting in some degree the limitations of the Exchange's surveillance program in this area.

Judging by the penalties imposed, it would appear that violations of the Exchange's minimum commission schedule constituted serious violations in the view of the Exchange.[119] In one of two such cases, an allied member was suspended for 5 years for his participation in a series of payments made by his firm to customers, purportedly for statistical and advisory services. The board determined that the payments made by the firm were rebates of commissions in violation of the Exchange's "commission law," and constituted acts detrimental to the interest or welfare of the Exchange. In the other commission rebate case, the Exchange suspended one partner of a member firm for 6 months and fined each of four other partners $5,000 for their participation in a scheme which involved the employment of individuals in nominal positions in order to reward those individuals for obtaining business for the firm.

The Exchange has demonstrated a greater reluctance to impose penalties of such severity for violations of ethical standards in dealing with customers. For example, the penalty imposed upon Stearns & Co. for trading by partners, employees, and their families against recommendations in the firm's market letter[120] was limited to a censure. A penalty of censure was similarly imposed on the partners of a firm, described in section 3(b)(3), in which lack of supervision had resulted in the sale of unregistered stock through its facilities. It is also significant that during the period of January 1, 1957, through September 30, 1962, the Exchange rarely brought a disciplinary action against a member organization for failure to supervise its salesmen properly. However, the Exchange decision in February 1963 involving the inadequate supervision of the Bache & Co. Seattle branch office, which was based on facts brought out at the Special Study's public hearings in May 1962, may point to a new disciplinary concern on its part in this area.[121]

(4) *Reporting of disciplinary actions*

The Exchange generally views its disciplinary proceedings as matters of concern primarily to the Exchange membership but not to the public. Current Exchange practice with regard to its formal disciplinary actions is to make public those in which a member or allied member is suspended or expelled, issuing a press release in which the member or allied member is named and the offenses described. In

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[118] The violations of the "know your customer" rule did not involve improper selling practices. See sec. b(3), above.

[119] This disciplinary concern with the minimum commission schedule is not a recent development. Samuel Untermeyer, counsel for the Pujo committee, a congressional committee which investigated stock exchange practices in 1912–13, testified at the Pecora hearings in 1934 that: "A former president of the stock exchange testified as long as 22 years ago before the Pujo committee that the most grievous offense a member could commit would be to split commissions or to reduce the prescribed commissions." Hearings, Senate Committee on Banking and Currency on S. Res. 84, 72d Cong., and S. Res. 56 and S. Res. 97, 73d Cong., p. 7705 (1934).

[120] See ch. III.C.7. Also note the Commission's position regarding this kind of practice by a registered investment adviser, *S.E.C.* v. *Capital Gains Research Bureau, Inc.*, 300 F. 2d 745, 306 F. 2d 606 (en banc) (2d Cir. 1962), certification granted, 371 U.S. 967 (1963).

[121] For a description of the penalties imposed in this case, see ch. III.B.5.b.

other cases, the board votes whether an announcement should be made of its action, but almost invariably the vote is negative. In those cases, the Exchange may summarize the violation without the use of names and circulate it to the membership. If the case involves a novel question, the Exchange may also summarize the facts, again without the use of names, in an educational circular.

After a disciplinary case involving a member or allied member has been decided, the Exchange staff advises the Commission of the decision, whether or not a penalty is imposed, in a letter containing a general statement of facts which is not approved by the board of governors or advisory committee.

The Exchange does not advise the other exchanges or the NASD of the results of its disciplinary actions involving its members who are also members of those organizations, unless the cases would otherwise be made public, even if the violation directly involves the other exchange. For example, in disciplining a member firm for violating its net capital rule, the Exchange found that the violation was attributable to the firm's specialist operation on the Midwest Stock Exchange, and as a consequence, the firm restricted this operation. The Exchange did not advise the Midwest Stock Exchange of its action in the matter. Similarly the NASD is not generally advised of disciplinary cases involving its members even if over-the-counter transactions are involved, except that it is informed of suspensions and expulsions of their members before the matter is made public so that, in the words of one Exchange officer, "they would not have to wait to read this in the newspaper."

Under the Exchange Act,[122] the NASD is required to suspend or terminate the membership of any member who is suspended or expelled by a national securities exchange for conduct inconsistent with just and equitable principles of trade. In the *Du Pont*, *Homsey* case, where the firm was expelled for fraud and the senior partner was subsequently convicted of Exchange Act violations, no such charge was made.[123] This placed on the NASD the added burden of instituting and prosecuting its own proceeding against the firm. The exchange also does not automatically advise the NASD of findings of such conduct against registered representatives, who are subject to loss of NASD registration if a national securities exchange cancels, terminates, revokes, or suspends their registration for conduct contrary to high standards of commercial honor or just and equitable principles of trade.[124]

The question of the publicity to be given to the results of the disciplinary proceedings of self-regulatory organizations involves varying considerations. One point of view was expressed by the public governors of the American Stock Exchange at a meeting of the governors of that exchange in 1941:

> A National Securities Exchange is a quasi-public institution. If it is to continue to act in that capacity, it must render a full account of its stewardship to the public at all times.
>
> A National Securities Exchange has a definite public service to perform. That service is to maintain a free market for the sale and purchase of securities. If

[122] Sec. 15A(b)(4).

[123] A possible consideration is the fact that a vote of 17 governors is needed to expel for fraud, whereas 22 governors must vote to expel for conduct inconsistent with just and equitable principles of trade. NYSE constitution, art. XIV.

[124] NASD bylaws, art. I, sec. 2(a).

this service functions properly, business enterprise will be aided by the flow of capital into industry.

It must be a fundamental requirement that the members of a National Securities Exchange, to whom orders are entrusted by the public, should so conduct themselves that the highest degree of confidence may be placed in their integrity. Once this high standard has been established, there is no reason for not apprising the public as to the commission of a material offense by any member of the Exchange. The public should be given full information so that it may decide for itself whether its interest had been affected, either directly or indirectly.[125]

There are, however, considerations to be weighed on the other side of this question. Under some circumstances, publicity given to a particular violation would itself constitute added and perhaps unwarranted penalty to the offending member or member organization. Also, it is possible that the Exchange might be reluctant to take otherwise appropriate disciplinary action in some instances if the penalty had to be released to the press.

The case involving Robert M. Gintel is illustrative of the problem. At a meeting of the advisory committee held on February 23, 1960, the committee severely censured Gintel, a member, and fined him $3,000. The facts upon which the Exchange acted in this matter were substantially those considered by the Commission in the *Cady, Roberts* case, in which Gintel was suspended from the Exchange for a period of 20 days.[126] In a memorandum an Exchange staff member took the position that the Exchange should not publicize any action taken against Gintel because of the impact of such publicity on the pending Commission case against him, and because publicity regarding this situation, which involved the use of inside information, might—

result in improper interpretation on the part of both member firms and the public that the Exchange had established a principle that the use at any time of information which had not been given general publicity is, per se, an offense against the public interest constituting conduct inconsistent with just and equitable principles of trade or acts detrimental to the interest or welfare of the Exchange when no such conclusion is intended.

Although the staff believed that Gintel's conduct was reprehensible and warranted disciplinary action, it took the position that the additional publicity "might well tend to magnify the penalty to the point where the punishment may be considered inconsistent with the offense."

In weighing these various factors bearing on the question of publicity of disciplinary actions it would seem that the public's interest in the Exchange's regulatory activities and in the conduct of member firms should ordinarily override other considerations.

d. Disciplinary actions involving registered representatives

While the rules governing the conduct of registered representatives are established by the board, their enforcement through disciplinary proceedings is left almost exclusively to the staff of the Department of Member Firms.[127]

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[125] At the time this statement was made, Amex policy was to give full publicity to disciplinary actions against its members involving financial loss on the part of the public, but not to publicize action when the Exchange felt that the public interest was not directly involved. The recent Commission staff report on the Amex (app. XII–A) discusses the Amex policy of not reporting such actions in 1961. Under the new administration of the Exchange, a more liberal reporting policy is in effect.

[126] *In the Matter of Cady, Roberts & Co.*, Securities Exchange Act release No. 6668 (Nov. 8, 1961).

[127] See ch. II.C.3.c. for a discusion of the standards and procedures employed by the Exchange in determining whether or not a salesman will be permitted to become registered with a member firm.

Under current procedures, when an incident is uncovered which tends to indicate that a registered representative has violated Exchange rules, a memorandum summarizing the findings of the staff regarding the case and recommending a proposed penalty or disposition is submitted to the vice president in charge of the department. The recommended disposition may take the form of the withdrawal of approval, suspension, fine up to $2,000,[128] censure, admonition, or warning, or a combination of these penalties. Prior to December 1962, the vice president in charge of the Department of Member Firms generally made the final determination of the disposition of any disciplinary matter involving a registered representative, except that in cases involving a suspension or withdrawal of registration approval of the president was necessary. Since that time all decisions involving lesser sanctions must be reviewed by the executive vice president of the Exchange. The opinion of the Exchange's general counsel as to whether the record supports the proposed decision is customarily obtained in any case which involves detriment to a salesman's economic position.

The Exchange in 1962 took steps to make the procedures in registered representative disciplinary cases more closely parallel those in member and allied member cases, but significant differences still exist. In registered representative cases a memorandum of facts prepared by the staff is now furnished the salesman so that he may comment on the alleged violations. In addition, the Exchange has granted salesmen the right to board review of Exchange disciplinary actions.[129] A right of review was previously available only if the firm which employed the salesman was willing to appeal on his behalf, although on one occasion a salesman was permitted by the staff as a matter of discretion to appeal a decision he considered arbitrary. Nevertheless, the Exchange staff and not the board makes all initial determinations of fact and the penalties to be imposed, subject to a right of appeal to the board, while for members and allied members these determinations are made by the advisory committee or the board. In addition, registered representatives, unlike members and allied members, are not entitled under Exchange rules to produce witnesses or cross-examine opposing witnesses.

No formal opinion is issued by the Exchange staff in registered representative cases. During 1962 it adopted the procedure of preparing a summary sheet on each case, containing a short synopsis of the facts of the case, certain findings of fact, and the proposed disposition. This summary sheet is principally designed, however, to make it easier for the president and executive vice president to review the file. No publicity is given to the disposition of these cases except that an educational circular is issued without the use of names where the Exchange believes it is appropriate. The Commission is advised monthly of registered representative disciplinary cases; the description usually consists of a sentence summarizing the case. No report of the disposition of cases is made to the NASD or the other exchanges.

An indication of the volume and type of disciplinary cases involving registered representatives during the period from January 1, 1957,

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[128] The power to fine salesmen was given to the staff by an amendment to the NYSE rules in January 1963. NYSE rule 345.

[129] NYSE rule 345, effective Jan. 17, 1963.

through September 30, 1962, is contained in table XII–3. During this period, a total of 396 cases were decided, averaging almost 6 cases per month. The table reflects a total for the various types of violations of 452 since, in certain cases, more than one kind of violation was involved. Table XII–4 breaks down the penalties in these 396 cases by disposition.

A particular problem is presented in disciplinary cases involving registered representatives when the representative is also a branch manager. Although the Exchange frequently has given separate consideration to the personal transactions and conduct of branch managers, there have been instances in which it might have shown greater concern about the continuation of the representative as a branch manager in light of the supervisory responsibilities with which he was charged. The case of Russell Siebach highlights the problem.

His application to become the Huntington, N.Y., branch manager of the office of Sutro Bros. & Co. was approved by the Exchange in September 1960.[130] Within a month after his approval as a branch manager, he was questioned by Exchange staff members in connection with alleged irregularities while with another member firm. On March 10, 1961, he was censured by the Exchange for delay in payment for securities purchased in his own account. In the course of the investigation leading to this censure, an Exchange staff member submitted a memorandum which stated in part:

> It is evident that Mr. Siebach handled his own account in a rather haphazard manner. He seems to purchase securities with no definite funds in line for payment. In speaking to * * * [the managing partner of a different NYSE member firm], the impression is conveyed that Mr. Siebach was the type of person that was, to a certain extent lax in following rules and regulations to their maximum.

Despite this, Siebach's branch manager approval was not withdrawn or affected in any manner. He subsequently became involved in further, more serious violations and admitted, in testimony given in the Commission's public proceedings to revoke the registration of that firm, that he had arranged credit in violation of Regulation T, had various dummy accounts at other firms, and had engaged in unauthorized transactions for his customers.

4. REGULATION OF THE CONDUCT OF MEMBERS ON THE FLOOR OF THE EXCHANGE

This section deals with the efforts by the Exchange to regulate the conduct of its members on the floor. Chapter VI describes the operations of the exchange markets, in terms of various functions performed by different classes of members on the floor. Its discussion of specialist and floor traders necessarily involves some treatment of the Exchange's participation in the regulation of these types of members, while the description of the odd-lot system and its regulatory background makes clear that the Exchange has adopted a passive role in the regulation of the odd-lot firms and their associate brokers. However, while chapter VI focused on the standards imposed by the Exchange, this section concerns the Exchange's enforcement of those standards. It also deals with Exchange enforcement of its rule gov-

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[130] His experience prior to being approved is discussed in ch. II.D.3.c.